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ABSTRACT

The 1998 Amendments of the Higher Education Act require the U.S. Department of Education and the General Accounting Office to identify no fewer than 3 different market mechanisms for use in determining lender return on student loans while continuing to meet the other objectives of the Federal Student Loan Program. This report is the final report of a joint study group that analyzed various policy options for the Loan Program. The report does not make any recommendations about the course to follow. To study the market mechanisms, the study group reviewed reports and asked for proposals from study group members and others. The proposals were grouped into five general models: (1) adjustments to the current system; (2) the loan origin rights auction model; (3) loan sale; (4) the federal funding model; and (5) the market-set rate model. Chapter 1 of this report contains background material and a brief history of the Federal Family Education Loan Program. Chapters 2 through 6 contain an analysis of each of the models relative to the 13 criteria set out in the legislative mandate. Chapter 7 discusses income contingent repayment as it might be applied to any of the models. Sixteen appendixes contain supplemental information and the public comments from various experts on a draft version of the report. (Contains 19 tables and 2 figures.) (SLD)

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Alternative Market Mechanisms

for the Student Loan Program

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A Report by the U.S. Department of Education and the U.S. General Accounting Office

December 18, 2001

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United States General Accounting Office
Washington, DC 20548

December 18, 2001

The Honorable Edward M. Kennedy
Chairman
The Honorable Judd Gregg
Ranking Minority Member
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable John A. Boehner
Chairman
The Honorable George Miller
Ranking Minority Member
Committee on Education and the Workforce
House of Representatives

This report reflects the results of a collaborative effort between the U.S. General Accounting Office and representatives of the Secretary of Education. As required by Section 801 of the Higher Education Amendments of 1998,[1] we formed a study group to identify and evaluate a means of establishing a market mechanism for the delivery of student loans. This study group consisted of representatives of the Department of the Treasury, Office of Management and Budget, Congressional Budget Office, entities making Federal Family Education Loan Program (FFELP) loans and other entities in the financial services community, and other participants in the student loan market. The group met as a whole four times before the public release of a draft of this report, and various group members corresponded with GAO and Education between group meetings as well. Serving on the study group does not constitute agreement either in whole or in part with the proposed models or the analysis of models presented in this report. Some study group members have provided additional or dissenting views, which are presented as appendixes to the report.

The mandate called for the evaluation of at least three different market mechanisms relative to 13 criteria. In consultation with the study group, we selected five general models for further evaluation—adjustments to the current system and four additional market mechanism models. In study group meetings and other conversations with group members, including those with staff from the other government agencies, we discussed the various models and their implications. The Overview contains a summary of the five models and our evaluation of each relative to the 13 criteria. In addition, we analyzed the potential to use an income-contingent repayment (ICR) option, similar to that used in the Federal Direct Loan Program, in each model. Because our analysis of this option was similar across all models, we discuss it separately in Chapter 7.

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[1] P.L. No. 105-244, Sec. 801 (1998).

Adjustments to the current system, in which information would be collected from current market transactions for use in determining the appropriate level of lender yield and which the Congress or some independent entity would still set through statute or regulation, would involve the least change from the current FFELP. The loan origination rights auction model would involve lenders bidding for the right to originate loans (either for the right to procure a certain volume, with which they could originate loans at any school, or for the right to originate loans at particular schools). In the loan sale model, the government or a government-designated entity would originate loans. Private lenders would then bid in an auction to purchase these loans after they have been originated. The federal funding model affords lenders the opportunity to borrow funds from the federal government to make FFELP loans at a predetermined interest rate or at an interest rate determined by some type of bidding process. Lastly, the market-set rate model allows lenders and borrowers to negotiate their own interest rates and perhaps other loan terms.

We made a draft of this report available to the public for comment as mandated by section 801of the 1998 Amendments to HEA. Written and electronic comments were received from eight organizations and two individuals during the 60-day comment period of January 19, 2001, to March 19, 2001, and these comments were made available to the study group for review. The Overview contains a summary of these comments, which are reprinted in apps. IX-XVI.

We are sending copies of this report to interested parties and making it available upon request. If you or you staff have any questions regarding this report, please contact me at (202) 512-7215.

Sincerely yours,

Barbara D Bovbjerg

Barbara D. Bovbjerg
Director, Education, Workforce,
and Income Security

UNITED STATES DEPARTMENT OF EDUCATION

THE DEPUTY SECRETARY

December 18, 2001

The Honorable Edward M. Kennedy
Chairman
The Honorable Judd Gregg
Ranking Minority Member
Committee on Health, Education, Labor, and Pensions
United States Senate

The Honorable John A. Boehner
Chairman
The Honorable George Miller
Ranking Minority Member
Committee on Education and the Workforce
House of Representatives

Dear Messrs. Kennedy, Gregg, Boehner, and Miller:

Section 801 of the Higher Education Amendments of 1998 (P.L. 105-244) requires the Comptroller General and the Secretary of Education, in consultation with a study group, to identify not fewer than three different market mechanisms for use in determining lender return on student loans while continuing to meet the other objectives of the Federal student loan programs. Enclosed is the joint final report of the study group, *Alternative Market Mechanisms for the Student Loan Program.*

The study group met four times to discuss the issues outlined in the statute. At the beginning of its work, the study group's members determined that the statute required an analysis of various policy options that would allow policymakers in the Congress and the Administration to make decisions about the future of the loan programs. Accordingly, the report contains analyses of various options but does not attempt to make any recommendations. In January 2001, the General Accounting Office (GAO) and the Education Department (ED) released a draft report for public comment. After the sixty-day comment period ended, GAO and ED reviewed the public comments and made changes where appropriate.

If you have any questions regarding this report, please feel free to contact me.

Sincerely,

William D. Hansen

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www.ed.gov

Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation

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Abbreviations

AGI	adjusted gross income
CBO	Congressional Budget Office
CP	Commercial Paper
DCS	Debt Collection Service
EPA	Environmental Protection Agency
FAFSA	Free Application for Federal Student Aid
FCC	Federal Communications Commission
FDLP	William D. Ford Federal Direct Loan Program
FFELP	Federal Family Education Loan Program
FHA	Federal Housing Administration
GSE	government sponsored enterprise
HEA	Higher Education Act of 1965
HEAL	Health Education Assistance Loan
HHS	Department of Health and Human Services
ICR	income-contingent repayment
IDEA	Income Dependent Education Assistance
IRS	Internal Revenue Service
OMB	Office of Management and Budget
PLUS	Parent Loan for Undergraduate Students
PRC	Postal Rate Commission
SAP	special allowance payment

OVERVIEW

In the Federal Family Education Loan Program (FFELP), lenders annually make more than $22 billion in loans to eligible student borrowers who attend postsecondary institutions and their parents. Additionally, through the William D. Ford Federal Direct Loan Program (FDLP), the federal government makes more than $11 billion available to these borrowers. The federal government insures FFELP loans against default and assures lenders of a specified yield that adjusts with interest rates.[1] Borrowers pay interest at a variable rate up to a maximum rate established by law. The federal government pays a "special allowance" to lenders—the difference between a borrower's rate and the specified yield—when the borrower's rate is lower. The Congress occasionally adjusts both the borrower's rate and the lender's yield.

In setting lender yield, the Congress attempts to ensure a yield high enough to maintain lender participation in the program but not so high as to require spending more taxpayer dollars than necessary. While the Congress considers information from Education, other federal agencies, and program participants in setting the lender yield, it often lacks critical information on the costs to lenders of making and servicing loans. Thus, setting lender yield is difficult, as illustrated by the extensive deliberations surrounding the 1998 reauthorization of the Higher Education Act of 1965 (HEA).

When the Congress considered the reauthorization of HEA in early 1998, both House and Senate committees expressed concern about the process of setting lender yield. The House Committee on Education and the Workforce stated in its report:

> "Currently, the Federal Family Education Loan (FFEL) program is a market-based program with private sector participation. However, to a large extent lender returns are set through a political process rather than a market process. This is disturbing for two reasons. First, if lender yield is set too low, private capital will become unavailable, and the student loan programs will collapse. Second, if the rate of return is set too high, the Federal Government forgoes savings that could be put to better uses or returned to the taxpayer."[2]

The report of the Senate Committee on Labor and Human Resources expressed similar concerns when it stated that the committee "has wrestled with its desire to balance the twin objectives of reducing the interest rate paid by borrowers and preserving access to loans under the FFEL program."[3]

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[1] FFELP loans are guaranteed by one of 36 nonprofit agencies designated by the Secretary of Education. If a loan goes into default, the guaranty agency generally pays the lender 98 percent of principal and accrued interest. The federal government then generally reinsures 95 percent of the guaranty agencies' payments to lenders (and also pays them fees for loan processing and issuance, account maintenance, and default aversion). The lender's yield is the face value of the interest rate on the FFELP loan. Currently, this is specified in legislation as the 90-day commercial paper rate plus 2.34 (1.74) percentage points for loans (not) in repayment.

[2] H.R. No. 105-481, at 154-5 (1998).

[3] S.R. No. 105-181, at 53 (1998).

The 1998 amendments to HEA required that GAO and Education jointly convene a study group to identify and evaluate means for establishing a market mechanism for the delivery of student loans. See appendix I for the full text of the mandate. This study group consisted of representatives of the Department of the Treasury, the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), entities making FFELP loans, other entities in the financial services community, other participants in the student loan programs, and other individuals designated by GAO and Education. See appendix II for a list of study group members. GAO and Education, in consultation with the study group, were charged with identifying at least three different potential market mechanisms and evaluating them with respect to 13 criteria laid out in the mandate.

In January 2001, a draft report prepared by GAO and Education was released for public comment. The draft report analyzed several models based on research and analysis, discussions with study group members, and comments received from others not on the study group. Serving on the study group does not constitute agreement either in whole or in part with the proposed models or the analysis of models presented in this report. Some study group members have provided additional or dissenting views, which appear here as appendixes.

BACKGROUND AND METHODOLOGY

Lenders in FFELP make loans to student and parent borrowers and receive a yield—an interest rate on the loans—that is set by legislation. Borrowers choose a lender, typically from a list their schools maintain. A guaranty agency reviews the loan application and issues a guarantee on the loan. As long as the loan is serviced properly, the guarantee is maintained, and the guaranty agency repays the lender if the borrower defaults on the loan. Education oversees lender, school, and guaranty agency participation in the program and reimburses the guaranty agencies for default payments provided to lenders. In addition, Education makes payments to lenders to make up the difference, if any, between the interest rate the borrower pays and the yield the lender is entitled to receive.

The yield that lenders receive from FFELP loans has been adjusted occasionally since 1977.[4] For Stafford loans and their predecessors, the Congress set lender yield generally at the 91-day Treasury bill (T-bill) rate plus a markup of 3.5 percentage points in 1977. The Congress made downward changes in the markup over the T-bill rate in 1986 and 1992. In 1995, different rates for loans in different stages were established, so that the markup was reduced for loans that were in school, grace, or deferment periods relative to the markup for loans in repayment. Both markups were reduced further in 1998. Finally, in 1999, the Congress changed the basis for the yield from the 91-day T-bill to the 3-month Commercial Paper (CP) index.[5]

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[4] Before 1977, a committee composed of the Secretary of Health, Education, and Welfare, the Secretary of the Treasury, and the Director of OMB decided the level at which lender yield should be set. Since 1977, the yield has been established by using a formula set in legislation rather than by a committee's determination, and the Congress adjusts this formula periodically.

In making these changes, the Congress has generally tried to set a yield that would maintain lender participation in the program without spending more than is necessary. Lenders require a reasonable return on their investment in the program to continue to take part in it. Without a reasonable return, they would be likely to devote their resources to more profitable investments, jeopardizing the continued availability of loan capital for FFELP. However, if the yield is set too high, federal funds could be wasted.

In order to explore ways of bringing market information to bear on the yield-setting process, the Congress, in the 1998 HEA reauthorization, mandated a study of the potential use of market mechanisms in FFELP. The mandate calls for evaluating at least three different market mechanisms relative to 13 criteria. We grouped the evaluation criteria into four sets, as shown in table 1.

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[5] The lender's yield is the face value of the interest rate on the FFELP loan. Currently, this is set in legislation at the CP rate plus 2.34 percentage points for loans in repayment. It is the lender's total interest revenues as a percentage of the value of the loans. A lender's net yield is the lender's yield less all costs, which include the costs of (1) raising funds to make the loans, (2) servicing the loans, (3) defaults, and (4) other administrative expenses. Loan servicing functions include maintaining contact with borrowers, billing for repayments, and taking steps to avoid defaults if loans become delinquent.

Table 1: The Four Sets of Evaluation Criteria

Set	Related criteria from the 1998 HEA amendments
Description of model, including variations	A description of how the mechanism will be administered and operated (12) The proposed federal and state role in the operation of the mechanism (11) Transition procedures (13)[a]
Costs, savings, and effects on subsidies for program participants	The cost or savings of loans to or for borrowers, including parent borrowers (1) The cost or savings of the mechanism to the federal government (2) The cost, effect, and distribution of federal subsidies to or for participants in the program (3)
Effects on lender participation, loan availability, and service quality	The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders (7) The availability of loans to students by region, income level, and categories of institutions (10) The effect on loan availability during a transition period (13)[a] The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower (6) The degree to which the mechanism will provide market incentives to encourage continuous improvement in delivering and servicing loans (9)
Simplicity, regulatory burden, and program integrity	The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants (5) The effect on program integrity (8)

Note: The numbers in parentheses refer to the number assigned to the specific criteria in the legislative mandate. The analysis related to the fourth criterion—the ability of the mechanism to accommodate the potential distribution of subsidies to students through an income-contingent repayment (ICR) option—was similar across all models. Rather than repeat our analysis of this criterion for each model, we discuss it separately in chapter 7. Therefore, this criterion does not appear in this table.

[a] We split the thirteenth criterion, on transition procedures, into a descriptive part and a part related to loan-availability issues.

THE FIVE MODELS

To identify different market mechanisms for analysis, we reviewed reports and asked study group members and others to submit proposals. We looked primarily for models in which some type of market process either determines the lender yield or provides information used to set the yield.

We grouped the proposals into five general models because similar characteristics emerged among some of the proposals. In study group meetings and other conversations with group members, including those with staff from the other government agencies, we discussed the various models and their implications. We also researched comparable programs where they existed, such as other federal auctions and the experiences of student loan programs in other countries.

The five models would make a variety of changes to FFELP.

The first of the five models we identified—adjustments to the current system—would involve the least change from the current FFELP. Information would be collected from current market transactions for use in determining the appropriate level of lender yield, which the Congress or some independent entity would still set through statute or regulation.

The loan origination rights auction model would involve lenders bidding for the right to originate loans (either for the right to procure a certain volume, with which they could originate loans at any school, or for the right to originate loans at particular schools). A lender's bid might consist of a specific yield level, so the yield would be directly determined by this mechanism. Alternatively, the bid might consist of a dollar amount for the right to originate loans, with the lender's yield on these loans set outside the process.

In the loan sale model, in contrast, the government or a government-designated entity would originate loans.[6] Private lenders would then bid in an auction to purchase these loans after they have been originated. Again, the lender yield would be set outside the process, and lenders' bids to purchase these loans would determine their net yield.

In the federal funding model, lenders would have the opportunity to borrow funds from the federal government to make FFELP loans. They would borrow either at a predetermined interest rate or at an interest rate determined by some type of bidding process. The lender's yield would still be set by the Congress, but by changing lenders' funding costs, this model would determine the net yield for lenders.

Finally, in the market-set rate model, lenders and borrowers would negotiate their own interest rates and perhaps other loan terms. Regulatory limits, such as a limit on the range of interest rates a lender would be allowed to offer, could be imposed. This process would set both the lender yield and the borrower interest rate.

Table 2 shows some of the major differences between the models, although most of the models have several variations that would allow for further differentiation.

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[6] Schools could potentially originate loans as currently practiced in FDLP.

Table 2: General Differences Between the Five Models

Question to differentiate the models	Adjustments to the current system	Market mechanism model			
		Loan origination rights auction	Loan sale	Federal funding	Market-set rate
How does the model work?	The Congress or its designee would use market information to set lender yield	Lenders would bid for the right to make (1) a certain volume of FFELP loans or (2) loans at specific schools	Lenders would bid to purchase loans after the government or some designated entity originated the loans	Lenders would be allowed to borrow funds from the government to make FFELP loans	Lenders and borrowers, or schools on the borrowers' behalf, would negotiate interest rates
What rates or costs does the market determine?	Rates or costs are determined only indirectly, based on market information	Either version above could determine (1) the lender's yield or (2) lender's cost to receive a given yield	Lender's cost to acquire the loan and ensure a given yield	Lender's funding cost	Lender's yield and borrower's interest rate
Who originates loans?	Private lenders	Private lenders	Federal government, through contractor or other entity	Private lenders	Private lenders
Are private lenders restricted in how much, or at which schools, they originate?	No	Yes, in some cases	Not relevant	No	Unclear
Is the borrower's rate or ability to choose the lender changed?	No	Yes, for lender choice	Yes, for lender choice	No	Yes, for both rates and choice of lender
How does the role of schools change?	No change	Schools may lose choice of lenders	Schools may serve as the originator of the loan	No change	Schools would play a stronger role in determining which lenders to use

THE STRUCTURE OF THIS REPORT

Chapter 1 of this report includes background material, a brief history of FFELP, and a description of the study group's work. Chapters 2 through 6 contain the analysis of each of the five models, relative to the 13 criteria set out in the mandate. Chapter 7 then discusses ICR as it might be applied to any of the models.

PUBLIC COMMENTS

We made a draft of this report available to the public for comment as mandated by section 801 of the 1998 Amendments to HEA. Eight sets of written and/or electronic comments were submitted by eight organizations and two individuals during the 60-day comment period of January 19, 2001, to March 19, 2001 (see apps. IX-XVI). These comments were made available to the study group for review.

In summary, several of the respondents specifically recommended that FFELP continue without change and that the current formula for lender yield remain in place. Several also expressed the opinion that maintaining the availability of loans to borrowers and student access to higher education was of greater importance than reducing federal program costs. One respondent suggested that continued participation of local lenders helped ensure access for risky or less profitable borrowers.

Several respondents expressed concern about potential consequences associated with introducing one or more of the market mechanism alternatives. Some stated that adjustments to the current system would cause the least disruption, while others stated that all market models could cause disruptions. While a number of respondents expressed concern that market-set rates had the potential for discrimination and denial of access to funds, one respondent stated that market-set rates may cause less disruption than other market models.

Two respondents commented mainly on the ICR option. They expressed concern regarding Education's payment calculator, used by borrowers to compare the monthly payments of ICR with other available loan repayment options, because it projects the total payments of repayment plans by adding up the total dollars to be repaid. They commented that adding up the total dollars can prove misleading. To remedy this, they recommended using a repayment calculator that calculates the present value of total dollars to be repaid and noted that such a payment calculator is available on the Internet. The respondents also referred interested readers to a forthcoming book on ICR. Additionally, some respondents believed that the draft report exaggerated the cost advantages of FDLP over FFELP. Several respondents also provided technical comments that we incorporated where appropriate.

CHAPTER 1

PROGRAM BACKGROUND AND 1998 HEA MANDATE

FFELP, established by HEA, as amended, provides more than $22 billion of loans annually to students pursuing a postsecondary education and their parents. Since 1965, FFELP has made higher education affordable for more than 40 million Americans. Access to FFELP loans is nearly universal among students enrolled at least half time at postsecondary education institutions eligible to receive at least an unsubsidized loan. More than 21 percent of all undergraduate students receive FFELP aid.[7] Lenders make loans to eligible borrowers, and the federal government guarantees the loans against default. Borrowers attending schools that participate in FFELP are legally free to choose their own lender. Many borrowers select a lender from a list provided by the school. Borrowers receive loans with differing levels of subsidies, which are based on financial need and length of time in school. The federal government ensures that lenders receive a certain yield, currently based on a CP interest rate, on FFELP loans. The federal government pays lenders the difference between the borrower's interest rate and the lender yield. The Congress adjusts this yield occasionally, but because critical information on lenders' costs and profitability is not available, the Congress cannot be sure that a particular yield will ensure sufficient lender participation without spending more than necessary. To help the Congress consider market-based alternatives to legislation, the Congress directed that GAO and Education form a study group with government and non-government experts to analyze ways in which lender yield in FFELP could be set through a market mechanism for the delivery of student loans. In accordance with the 1998 amendments to HEA, each mechanism was to be evaluated relative to 13 criteria set out in the mandate. The study group considered a number of proposals, and GAO and Education conducted an analysis of five models that involve market processes to different extents.

HOW THE FEDERAL LOAN PROGRAMS OPERATE

HEA has created two major federal loan programs for students pursuing postsecondary education.[8] In 1965, the original HEA established the guaranteed student loan program (subsequently renamed FFELP), in which loans are originated by lenders, guaranteed by state-chartered guaranty agencies, and reinsured by the federal government. In 1993, HEA authorized FDLP, a second major loan program, in which the federal government provides loan capital, schools originate loans directly to students, and outside contractors perform loan origination and servicing functions. Since that time, competition has increased in the student loan market and student borrowers have benefited from reduced fees and lower interest rates.

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[7] Based on an analysis of the 1995-96 National Postsecondary Student Aid Study sponsored by the National Center for Education Statistics.

[8] HEA also authorized the Perkins Loan program, a relatively small program that provides funds to postsecondary institutions that are used to establish a revolving fund from which loans to students are made. The Perkins Loan program—previously known as National Defense and National Direct Student Loan programs—predates HEA by 7 years.

Types of Loans

FFELP and FDLP both include four major types of loans: subsidized Stafford, unsubsidized Stafford, PLUS, and consolidation loans.[9] Student borrowers receive subsidized and unsubsidized Stafford loans. Parent borrowers receive PLUS loans. Borrowers may take out consolidation loans before or after entering their repayment period.

Subsidized Stafford Loans

Needs-based subsidized Stafford loans are available to eligible students at participating institutions. The guaranteed amount of a subsidized loan may not exceed a student's "unmet financial need."[10] The maximum loan amount is also subject to annual and aggregate loan limits.

A key feature of the subsidized Stafford loan is its interest subsidy while the student is not in repayment. The government pays, on the borrower's behalf, all interest accruing on the outstanding principal while the borrower is attending school at least half-time, for 6 months after attendance (the "grace period"), and for periods of authorized deferment. Stafford borrowers participating in the standard repayment plan have a repayment period of 10 years, not counting periods of authorized deferment and forbearance.[11]

FFELP and FDLP lenders may also offer graduated and income-sensitive or income-contingent repayment plans to borrowers. Borrowers have the option of picking a different repayment plan each year. If borrowers waive their selection, rules of the standard repayment plan apply.

As previously noted, the interest rate on subsidized Stafford loans is currently the 91-day T-bill rate plus 1.7 percentage points when the borrower is in school or in other nonpayment periods and the T-bill rate plus 2.3 percentage points when the borrower is in repayment. The rate is reset on July 1 each year, based on the T-bill rate from the last Treasury auction conducted before June 1.

Unsubsidized Stafford Loans

Unsubsidized Stafford loans differ from subsidized Stafford loans in three key respects: They are not need-based, the government does not pay interest during in-school periods, and loan limits are higher. The unsubsidized Stafford loan is not need-based; the approved amount is not limited by the same financial need formula used for subsidized Stafford loans. Instead, the expected amount of the unsubsidized Stafford loan may be considered all or part of the estimated family contribution. Interest on the unsubsidized Stafford loan is paid entirely by the borrower and is not subsidized by the federal government. The borrower is not required to make interest payments during in-school, grace, and other deferment periods. However, interest accrued during such periods may be capitalized (added to principal) when the loan enters repayment for the first time or when it returns to a repayment status following a period of deferment. Higher loan limits are available on unsubsidized Stafford loans to independent students.[12] The maximum borrower's interest rate is the same as for subsidized Stafford loans.

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[9] Originally, "PLUS" stood for the official name of the program, "Parent Loans for Undergraduate Students." Under current law, the program is simply named PLUS. Formula interest rates charged to students under FDLP were set in law generally equal to the formula maximum rates on corresponding FFELP loans.

[10] "Unmet need" is, in its simplest terms, the borrower's cost of attendance minus estimated family contribution minus estimated financial aid from other sources.

[11] A deferment is a period during which borrowers do not need to pay principal and the federal government pays interest. Borrowers are eligible for a deferment under certain conditions, such as going on to further schooling. A forbearance is a period during which borrowers do not need to pay principal but are responsible for any interest that accumulates. The borrower's eligibility for a 10-year repayment schedule is conditioned by the requirement that the borrower repay at least $600 per year. The 1998 amendments to HEA provide for a repayment schedule of up to 25 years for "new borrowers" who accumulate more than $30,000 in FFELP loans.

PLUS Loans

The PLUS loan is available to parents for their student dependents. For a school to certify a PLUS loan, both parent and student must meet program eligibility requirements. For the PLUS loan, HEA requires the lender to determine that the parent borrower does not have an "adverse credit history" before making the loan and to use as a minimum the guidelines for determining adverse history in the student financial aid regulations. If the lender discovers adverse credit history in the applicant's credit bureau report, it can still make the loan if it documents "extenuating circumstances." Even without extenuating circumstances, the lender can still make the loan if the borrower obtains a creditworthy endorser.

Like the unsubsidized Stafford loan, the PLUS loan is not need-based and may replace all or part of the student's estimated family contribution. Also like the unsubsidized Stafford loan, payments of interest on the PLUS loans fall upon the borrower entirely, with no federal subsidy. Payments of interest are not required during periods of authorized deferment but may be capitalized upon expiration of the deferment.

Unlike both types of Stafford loans, there is no fixed annual or aggregate limit for PLUS loans. A loan may not be made, however, for an amount greater than the student's cost of attendance less his or her estimated financial aid. Also unlike Stafford loans, the PLUS loan has no grace period—it enters repayment upon full disbursement, unless the borrower happens to qualify for a deferment. Unless payments are deferred, the first payment due date for a PLUS must be established within 60 days of final disbursement.

Consolidation Loans

Consolidation loans are new originations that do not contribute to the increases in outstanding balances because they refinance already existing loans. Borrowers may consolidate FFELP loans, FDLP loans, and Perkins loans authorized by legislation other than HEA.

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[12] Independent students are students who, by meeting certain regulatory criteria, are presumed to receive no financial support from their parents. A student is considered "independent" who is at least 24 years old and who is a graduate or professional student, a veteran of the U.S. armed forces, or married or has dependents other than a spouse. A financial aid administrator may also classify a student as independent under special circumstance, even if none of these criteria is met.

The purpose of the consolidation loan program is to give a borrower who has multiple loans—possibly from different lenders, different guarantors, and even from different loan programs—the opportunity to have them combined into a single debt. The consolidation loan offers two unique advantages. First, the borrower who has been dealing with multiple servicers and repayment schedules can deal with a single servicer and single repayment schedule. Second, a combined debt of more than $7,500 qualifies the borrower for a repayment term longer than the maximum 10 years generally available on Stafford and PLUS loans. For example, consolidation loan borrowers with at least $20,000 of combined qualifying debt may qualify for a repayment period of 20 years, borrowers with more than $60,000 for the maximum 30 years.[13] Periods of deferment and forbearance are not included.

Borrowers who consolidate their loans give up certain benefits tied to the underlying loans subject to consolidation. These benefits include certain deferments and all service and employment cancellations available to borrowers under the Federal Perkins Loan Program. Borrowers also give up the variable interest rate of the FFELP and FDLP loans consolidated in lieu of a rate fixed for the life of the loan.

In recent years, consolidation loans have been used to resolve defaults. A borrower who has defaulted on an FFELP or FDLP loan may pay that defaulted debt in full by consolidating it. This has two effects. First, the borrower's credit history is improved—in some cases immediately and in others after payments have been made. Second, resolution of the default qualifies the borrower for additional student financial assistance. A borrower qualifies for consolidation of a defaulted loan by making a satisfactory repayment arrangement with its holder, as defined in regulations.

The availability of loan consolidation to borrowers must be considered as part of the analysis of any market mechanism proposal. Loan consolidation allows borrowers to change lenders. However, the ability to switch lenders affects the perceived federal benefit that could result from some of the market mechanism models discussed in this report.

Student Loan Volume and Default Rates

FFELP loans represent more than half of federal student loans outstanding and newly originated, and in both FFELP and FDLP, Stafford loans make up the bulk of overall outstanding loans. At the end of federal fiscal year 2000, the total amount of outstanding FFELP loans was about $166 billion, while about $58 billion of FDLP loans were outstanding. During fiscal year 2000, FFELP loans accounted for about 63 percent of new loan volume, FDLP for about 37 percent. Tables 3 and 4 detail loan balances and new loan originations, respectively, for fiscal year 2000.

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[13] This is based on the outstanding balances of all loans in the qualifying underlying loan programs.

Table 3: Outstanding Loan Balances at the End of Fiscal Year 2000

Loan	Federal Family Education Loan Program	Federal Direct Loan Program	Total loans	
			Amount	Percent
Stafford				
Subsidized	$85,084	$23,976	$109,059	48.7%
Unsubsidized	37,410	15,487	52,897	23.6
PLUS[a]	14,552	3,609	18,160	8.1
Consolidation	29,082	14,643	43,725	19.5
Total	**$166,128**	**$57,714**	**$223,841**	**100.0%**

Note: Dollars are in millions. Totals do not sum because of rounding.

[a] Includes loans from Supplemental Loans for Students, a program that no longer exists.

Source: Department of Education.

Table 4: Loan Originations in Fiscal Year 2000

Loan	Federal Family Education Loan Program	Federal Direct Loan Program	Total loans	
			Amount	Percent
Stafford				
Subsidized	$11,259	$5,785	$17,044	37.8%
Unsubsidized	9,126	4,240	13,366	29.6
PLUS	2,326	1,318	3,644	8.1
Consolidation	5,695	5,369	11,065	24.5
Total	**$28,406**	**$16,712**	**$45,119**	**100.0%**

Note: Dollars are in millions. Totals do not sum because of rounding.

Source: Department of Education.

The cohort default rate for federal student loan programs hit its highest level—22.4 percent—in fiscal year 1990 but has since greatly declined. The reduction in the default rates has been attributed to a variety of circumstances. Efforts by FFELP participants, actions by both the Congress and Education, the availability of additional repayment plans, and the strong economy have all contributed to decline. The most recent student loan default rates—the 1998 cohort default rates—showed that overall, the direct and guaranteed student loan programs had similar default rates—6.6 percent for FDLP and 6.7 percent for FFELP.

Participants in the Student Loan Programs

FFELP involves many participants, including borrowers, schools, lenders, loan servicers, guaranty agencies, and Education. Some of these participants also have roles in FDLP.

Borrowers

Every eligible student pursuing postsecondary education at least half-time at a participating school meeting certain requirements may obtain a loan. In addition, in some cases parents of undergraduates may also borrow through FFELP or FDLP. The loans can be used to pay for tuition and education-related expenses at eligible 4-year colleges and universities, 2-year community colleges, private colleges and universities, and for-profit trade and technical schools (sometimes referred to as proprietary schools).

For Stafford loans, student borrowers do not have to make payments while in school or in other authorized periods of nonpayment. Depending on the borrower's income, and the income of his or her family, he or she may be responsible for the interest that accrues during these periods of nonpayment, in which case it is added to the loan principal at the beginning of the repayment period. The maximum interest rate a borrower may be charged is set in legislation as the 91-day T-bill rate plus an add-on of 1.7 percentage points when the borrower is in school or in other nonpayment periods and 2.3 percentage points when the borrower is in repayment. The borrower rate is adjusted annually, based on the new value each year of the T-bill rate, but it is capped at 8.25 percent no matter how high the T-bill rate.

Schools

Eligible schools decide whether to participate in FFELP, FDLP, or both; most schools choose to participate in only one of the programs. In both programs, schools make various certifications necessary for a borrower to obtain a loan, and in FDLP they perform certain loan origination functions as well. Borrowers in FFELP schools are legally free to choose among all eligible FFELP lenders. Schools often provide borrowers a recommended list of lenders that is based on the services, loan terms (such as rate discounts for good performance), and other key services offered by the lenders.[14] Most borrowers use a lender that their school recommends.

Lenders and Secondary Markets

Lenders originate and hold FFELP loans. HEA limits eligibility to originate and hold these loans primarily to (1) banks and certain other savings institutions, (2) pension funds, (3) insurance companies, (4) one state or private, nonprofit agency for each state, and (5) with certain limitations, schools. Lenders pay the government an origination fee of one-half percent for each loan and, in the case of consolidation loans, a fee of 1.05 percent. The government offsets interest and special allowance payments owed to lenders to collect a 3 percent borrower origination fee and authorizes lenders to charge the borrower for this fee. Although lenders may discount the fee to the borrower, so that the borrower may not pay the full 3 percent, the lender must still pay the full fee to the government. The 1998 Amendments and regulations further specified the circumstances under which lenders may charge borrowers a reduced origination fee.

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[14] Service competition by lenders involving "inducements," such as mailing unsolicited loan applications or paying schools for referrals of loan applicants, is not permitted.

An eligible lender can approve and originate loans. Once the loan is originated, the lender can

keep the loan on its books and earn either a positive or negative return and interest spread based on the lenders' yield and its own interest expenses and other expenses,
sell the loan to a purchasing lender and record the gain or loss on sale, or
securitize the loan by selling the loan to a trust that has beneficial ownership of the loans and funds its holdings by selling debt to investors and book a gain or loss, depending on the terms of the transaction.

In the FFELP student loan market, secondary markets refer to financial institutions that purchase student loans from lenders and provide liquidity to the student loan market. In 1972, the Congress chartered a national secondary market, Sallie Mae, as a shareholder-owned government-sponsored enterprise (GSE) to provide liquidity for the student loan market. Some other lenders also serve as secondary markets for FFELP loans. In addition, under HEA, each state can designate a not-for-profit secondary market to help ensure that every student at every eligible institution can receive a loan and to provide liquidity to originators.

Financial institutions other than those defined as eligible by HEA are not eligible for direct participation as lenders in FFELP. However, HEA authorizes the use of trustees as eligible lenders to hold loans for the benefit of others without regard to the latter's own eligibility. Certain secondary markets, those that are not designated by their state to be the state's eligible lender, as well as other nonbank financial institutions, use trustees to originate loans.

Sallie Mae and some secondary markets also effectively manage or service an additional amount that was held by originators with which these secondary markets have "pipeline" arrangements. Some of the funding for loans in the pipeline is borrowed by the originating lender from the subsequent purchaser.[15]

In 2000, nearly 4,000 lenders took part in FFELP. Both loan holdings and loan originations were concentrated in larger institutions, as shown in tables 5 and 6. The top 10 loanholders held 68 percent of outstanding loan balances and the top 10 loan originators originated 52 percent of the loan volume in 2000. Both loan holdings and loan originations became increasingly concentrated, as shown in tables 5 and 6.

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[15] Under such arrangements, the secondary market performs all or some of the marketing, origination, funding, or servicing functions for the originating lender of record while the student is in school. The loan is transferred to the secondary market when or before the loan enters repayment pursuant to a forward purchase agreement, often at a predetermined price.

Table 5: Concentration of FFELP Outstanding Loan Balances at the End of Fiscal Years 1994-2000

Fiscal year end	% Share held by	
	Top 10 loanholders	Top 50 loanholders
1994	54	79
1995	55	82
1996	57	85
1997	58	87
1998	58	87
1999	62	89
2000	68	91

Source: Department of Education.

Table 6: Concentration of FFELP Loan Originations in Fiscal Years 1994-2000

Fiscal year	% Share originated by	
	Top 10 originators	Top 50 originators
1994	37	67
1995	37	69
1996	40	73
1997	45	78
1998	52	79
1999	52	**82**
2000	52	82

Note: Originations exclude consolidation loans.

Source: Department of Education

FFELP lenders' yield and eligibility requirements are set by federal statute and are administered by Education. This yield is based on a variable short-term index, which closely tracks changes in the market cost of funds. The formula for lenders' yield for new Stafford loans in FFELP—the largest component of FFELP—is now based on a CP index. Lender yield is the 90-day CP rate plus 1.74 percentage points while the borrower is in school or during other nonpayment periods and it is CP plus 2.34 percentage points when the borrower is in repayment. The lender yield is adjusted quarterly with new values of the CP rate. This rate applies to new FFELP loans made after January 1, 2000.

After July 1, 2003, the Stafford formula is scheduled to change to a markup of 1 percentage point over the rate for "comparable maturities" of Treasury securities, as determined by the Secretary of Education in consultation with the Secretary of the Treasury. This new rate is both the borrower's rate and the lender's yield. Such a change may narrow the interest margins earned by lenders and will likely increase their funding risks as well as increase the costs of hedging. Several study group members expressed concern that lenders may respond by exiting from FFELP, which could potentially limit borrower access to student loan funds and disrupt ongoing working relationships among schools, lenders, and students.

A special allowance payment (SAP) is a quarterly payment that the federal government makes to FFELP lenders. It equals the difference between the rate a borrower pays and what the current formula provides for lender yield. Thus, if the lender yield exceeds the maximum borrower rate, the government pays the difference to lenders in the form of the SAP. If the difference is negative, the lender receives the borrower rate and no SAP. The SAP is intended to maintain the incentive associated with the yield for the lender if interest rates change, while permitting borrowers to pay lower rates if interest rates fall. If CP declines, the quarterly lender yield declines, and so does the SAP generally. The minimum or "floor" yield to lenders is the borrower's rate for the year. The SAP is designed to make sure that the lenders receive a reasonable rate of return on average. However, because risks and costs can vary across borrowers and lenders, so can returns. Therefore, implementing a market mechanism that results in a variety of SAPs that reflect actual risks and costs could potentially lower the federal cost of the program.

The borrower's interest rate set in legislation is a maximum, and FFELP lenders may offer lower interest rates to borrowers. Most often lenders charge FFELP borrowers the maximum rates at the outset but then offer some rate reductions during repayment. For example, they may reduce rates after the borrower makes a certain number of payments on time or if the borrower chooses to make payments through electronic funds transfers. Many lenders now also offer rate reductions upon loan origination or discounts on the 3 percent origination fee.

Loan Servicers

Loan servicers undertake the processing necessary to ensure that cash flows of the loans are recorded and transferred to and from lenders, guaranty agencies, and Education. Loan servicing is more concentrated than are loan holdings or loan originations, with the top two loan servicers accounting for about 50 percent of the loan servicing market. Holders of student loans can service their own loans or they can contract out for loan servicing to be performed by another entity; this is known as a third-party servicer arrangement.[16] If servicing does not conform to procedures Education established by regulation, the lender may not be reimbursed if the borrower defaults. Better servicing can reduce the risk of default and thus lower government costs. Additionally, schools benefit because higher defaults could threaten some schools' eligibility to participate in FFELP.

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[16] Third-party servicers are not subject to eligibility limitations by organizational type. However, they must meet federal requirements of administrative capability and financial responsibility, and they are subject to audit by Education. Eligible lenders remain responsible for the performance of their legal duties, despite any delegation of functions to third-party servicers, and they must monitor their servicers' activities.

Guaranty Agencies

Guaranty agencies administer the federal guarantee on FFELP loans, confirm borrower eligibility, monitor the status of loans, provide delinquency and default aversion counseling, and provide claims adjustments. FFELP loans are guaranteed by one of 36 nonprofit or state agencies designated by the Secretary of Education. If a loan goes into default, the guaranty agency generally pays the lender 98 percent of principal and accrued interest. The federal government then generally reinsures 95 percent of the guaranty agencies' payments to lenders and also pays them fees for loan processing and issuance, account maintenance, and default aversion. Guaranty agencies also retain a portion of the collections they are able to make after a loan has gone into default. The government also directly guarantees or reinsures FFELP lenders against the inability of guaranty agencies to fulfill their guarantees because of insolvency.

As long as the lender complies with the regulations, the guarantee substantially limits FFELP lenders' losses due to borrower default. Federal reinsurance is available only if the guaranty agency correctly enforced federal regulations and attempted to collect from delinquent borrowers. If the loan servicing and collections are not done in accordance with federal regulations, the reinsurance can be voided and can create losses for the guaranty agency.

Guaranty agencies are authorized to collect a single insurance premium from FFELP borrowers of not more than 1 percent of the principal amount of their loans. Before 1998, some guaranty agencies had selectively reduced or eliminated this insurance premium. Since reauthorization eliminated the fee as a source of operating revenue, the elimination of guarantee fees has become widespread because of market pressures. Any fees collected go into an agency's federal reserve account, which consists of federal funds that the guaranty agency maintains to pay default claims.

The Department of Education

The Department of Education role in administering FDLP and FFELP differs significantly between the two programs. Under FFELP, also known as the guaranteed student loan program, money is borrowed from private lenders, such as banks, and the federal government guarantees repayment if the borrowers default. Under FDLP, students or their parents borrow money directly from the federal government through the schools the students attend, which include vocational, undergraduate, or graduate schools.

HEA provides the structure of FFELP program requirements and then authorizes the Secretary of Education to administer the program. Among the Secretary's responsibilities is the promulgation of regulations to provide detail on how requirements will be implemented. Sometimes, the statutory requirement is very specific, in which case, the regulation simply restates the statutory language (e.g., loan limits). In other cases, the statute expresses the requirement in only the broadest terms and gives extensive authority to the Secretary to define standards of compliance such as due diligence with respect to loan collection.

Education is also involved in two types of cash flows relevant to the topic of this report. First, it reimburses a guaranty agency after the guaranty agency pays a lender for a defaulted loan.

Second, it makes certain payments to lenders, including the difference between the borrower's interest rate and the lender's yield, for all borrowers, and interest during in-school and other authorized periods, for borrowers with subsidized Stafford loans. Education is also responsible for

- determining a student's eligibility to receive federal student financial assistance;
- gatekeeping, monitoring, and enforcement activities for postsecondary schools;
- recognizing accrediting agencies;
- monitoring the participation of guarantors, lenders, secondary markets, and third-party servicers in FFELP;
- managing FDLP;
- collecting and resolving defaulted FFELP and FDLP loans;
- maintaining a centralized database on individuals who apply for and receive federal student financial assistance;
- managing the financial aspects of the Federal Student Financial Aid Programs, such as receipt, disbursement, accounting, and financial reporting for federal funds;
- developing and disseminating information about the federal student loan programs;
- developing cost estimates for the student loan programs; and
- providing technical support and information for financial aid administrators.

The federal costs of FFELP include borrower defaults and loan discharges, borrower interest subsidies, and payments to lenders and guaranty agencies. The federal costs associated with FFELP for fiscal year 2000 are presented in table 7. Figure 1 depicts the cash flows in an FFELP program loan to and from the student borrower, school, lender, loan servicer, guaranty agency, and Education. Figure 2 depicts the cash flows associated with a FFELP program loan in default.

Table 7: Federal Costs for the FFELP Fiscal Year 2000

Item	**Amount**
Interest benefits	$1,943,067,250
Default claim reimbursement	1,646,483,901
Special allowance payments	975,825,865
Death, disability, and bankruptcy	309,476,408
Account maintenance fees	180,000,000
Loan processing and issuance fees	149,799,369
Collection costs	78,558,740
Total	**$5,283,211,533**

Source: Department of Education.

Figure 1: Cash Flows for an FFELP Loan From Origination Through Repayment

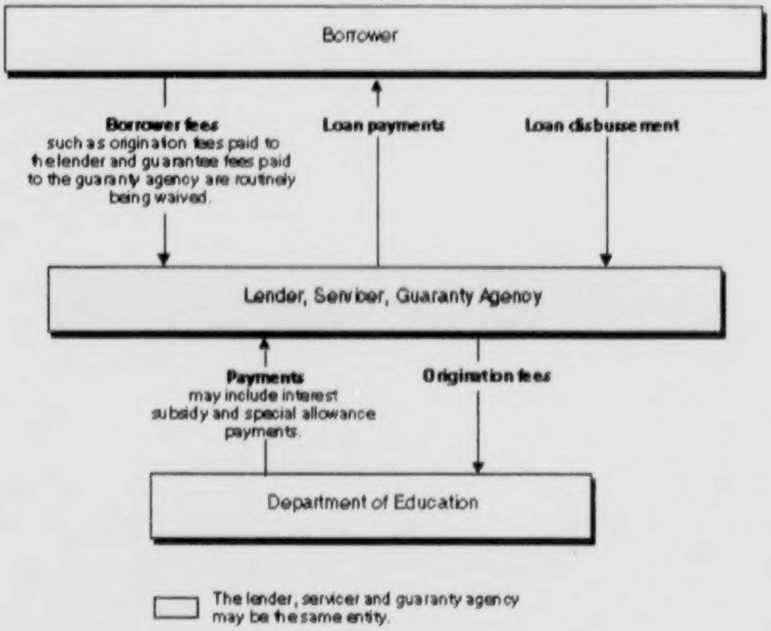
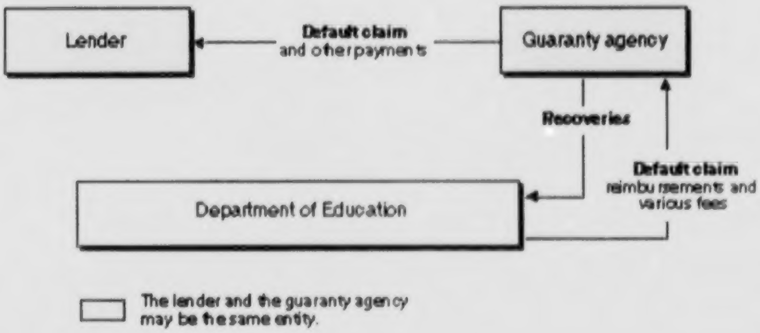

Borrower
Borrower fees
such as origination fees paid to the lender and guarantee fees paid to the guaranty agency are routinely being waived.
Loan payments
Loan disbursement
Lender, Servicer, Guaranty Agency
Payments
may include interest subsidy and special allowance payments.
Origination fees
Department of Education
The lender, servicer and guaranty agency may be the same entity.

Figure 2: Cash Flows for an FFELP Loan in Default


Lender
Default claim
and other payments
Guaranty agency
Recoveries
Default claim
reimbursements and
various fees
Department of Education
The lender and the guaranty agency
may be the same entity.

Determining the actual financial performance and the true costs of the FDLP at present is difficult. Because FDLP is a relatively new program, little repayment activity and historical data are available. This lack of historical FDLP data has caused Education to rely heavily on data from FFELP to develop estimates for most key cash flow items. Also, estimating the subsidy cost of FDLP is difficult because of their dependency on interest rate projections and corresponding fluctuations in subsidy costs which depend on the extent of changes in interest rates.[17]

MANDATE IN THE 1998 AMENDMENTS TO HEA AND THE STUDY GROUP'S WORK

The Study Group and Its Objectives, Scope, and Methodology

The 1998 amendments to HEA mandated that GAO and Education form a study group to identify and evaluate a means of establishing a market mechanism for the delivery of student loans. This study group consisted of representatives of CBO, OMB, Treasury, entities making FFELP loans, other entities in the financial services community, other participants in the student loan programs, and other individuals designated by the Comptroller General and the Secretary of Education. (See app. I for the full text of the mandate and app. II for a list of study group members.) The group met as a whole four times before the public release of a draft of this report, and various group members corresponded with GAO and Education between group meetings as well.

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[17] GAO recently reported that the estimated cost savings associated with FDLP are sensitive to changes in the student borrower rate and the rate at which Education borrows from Treasury. See *Department of Education: Key Aspects of the Federal Direct Loan Program's Cost Estimates* (GAO-01-197, Jan. 12, 2001).

The mandate calls for the evaluation of at least three different market mechanisms relative to 13 criteria. We grouped the evaluation criteria into four sets, as shown in table 8.

Table 8: The Four Sets of Evaluation Criteria

Set	Related criteria from the 1998 HEA amendments
Description of model, including variations	A description of how the mechanism will be administered and operated (12) The proposed Federal and State role in the operation of the mechanism (11) Transition procedures (13)[a]
Costs, savings, and effects on subsidies for program participants	The cost or savings of loans to or for borrowers, including parent borrowers (1) The cost or savings of the mechanism to the Federal Government (2) The cost, effect, and distribution of Federal subsidies to or for participants in the program (3)
Effects on lender participation, loan availability, and service quality	The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders (7) The availability of loans to students by region, income level, and categories of institutions (10) The effect on loan availability during a transition period (13)[a] The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower (6) The degree to which the mechanism will provide market incentives to encourage continuous improvement in delivering and servicing loans (9)
Simplicity, regulatory burden, and program integrity	The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants (5) The effect on program integrity (8)

Note: The numbers in parentheses refer to the number assigned to the specific criteria in the legislative mandate. The analysis related to the fourth criterion—the ability of the mechanism to accommodate the potential distribution of subsidies to students through an ICR option—was similar across all the models. Rather than repeat our analysis of this criterion for each model, we discuss it separately in chapter 7. Therefore, this criterion does not appear in this table.

[a] We split the thirteenth criterion, on transition procedures, into a descriptive part and a part related to loan availability issues.

The group solicited proposals for market mechanisms that might meet the intent of the mandate. Group members, as well as outside observers, submitted proposals for consideration. GAO and Education considered all submissions and grouped them where we saw some similarities within the proposals. For example, under the general idea of conducting an auction for the right to make FFELP loans, there were two main possibilities as to how such an auction might be conducted, as well as many different considerations at the level of specific auction design. Rather than selecting one of the main possibilities and a specific set of auction design decisions, we analyzed this type of model in general, weighing the advantages, disadvantages, and tradeoffs in the different possible choices.

In study group meetings and other conversations with group members, including staff from the other government agencies, we discussed the various models and their implications. Two of the group meetings were devoted to generating ideas about possible changes to FFELP, including some general factors to consider and some specific proposals. In the third meeting, the group discussed preliminary analysis results, and in the fourth meeting, the group discussed a draft of this report.

GAO and Education also researched comparable programs in existence, such as other federal auctions and the experiences of student loan programs in other countries. We used previously published reports, material available from the Internet, and contributions from study group members for much of this research.

The Five Models Discussed in This Report

The potential changes to FFELP discussed in this report are grouped under five general models:

adjustments to the current system,
loan origination rights auction,
loan sale,
federal funding, and
market-set rate.

A model involving adjustments to the current system would change the process of setting lender yield by building upon competition for loan originations, purchases, and servicing that is a part of FFELP today. Proposals within this model include (1) making periodic incremental downward adjustments in the lender yield while monitoring any resulting changes in lender participation; (2) using information about lenders' cost of funds and servicing costs to set the yield; (3) establishing an independent blue ribbon commission to gather information, analyze data, and either set lender yield or recommend a yield level to the Congress; and (4) using information from secondary market loan sales transactions to determine the value lenders place on loans, and establishing a one-time payment to lenders based on this value to replace the quarterly SAP.

A loan origination rights auction would require lenders to bid to participate in FFELP. The borrower's interest rate and other loan terms would be set through legislation or regulation and could remain the same as today. Lenders would generally submit bids to participate in FFELP loan origination, and bidders offering the best terms to the government would win the allocations. Variations within this type of model differ as to how restrictive the outcomes would be. A volume procurement auction would require lenders to bid on the right to an amount of loan volume at a particular interest rate (or price, for a predetermined interest rate), perhaps for volume within different sectors of schools.[18] An actual origination rights auction, in contrast, would require lenders to bid for the right to originate at groups of schools.

The loan sale model presumes that private lenders would purchase loans sometime after they are originated by the government or by some entity under government contract. The loan would be government property until sold at auction. The government would assemble packages of loans, and private lenders would evaluate the packages and submit bids. Loans would carry the same borrower terms as today, and the lender yield would be set legislatively and could be the same as the borrower's interest rate. Loan origination could be performed by the federal government; schools, private lenders that bid to originate and service the loans but operate under government contract, or state agencies or some other entity. Loans could be sold immediately after origination or held until a borrower graduates or otherwise completes schooling, at which time a borrower's loans could be sold as part of a package. Loan servicing could be performed by the purchaser, if servicing responsibilities are sold with the loan, or by some other entity.

The federal funding model would adjust funding costs for FFELP lenders, ultimately determining lender's net yield. Private lenders would continue to originate loans, except that they would be allowed to borrow funds from the federal government to make FFELP loans. The interest rate at which they borrow, in conjunction with the lender yield on FFELP loans, would determine lenders' net yield. This process could be made mandatory for lenders who want to participate in FFELP, or it could be offered as an option, with lenders still being allowed to fund student loans through traditional methods. Once lenders receive these funds, or if they choose not to participate, everything else would proceed functionally as in the current system. The funds lenders borrow from the government could be payable on either a regular amortization schedule or a schedule tied to borrower repayments on the FFELP loans made with the federal funds. Finally, the markup over a Treasury-based interest rate, such as the 91-day T-bill rate or the 10-year Treasury bond rate, could be fixed, or lenders could bid on the markup.

In a market-set rate model, the borrower or the school chooses among lenders for the best attainable interest rate. Unlike with the other models, the borrower's interest rate would no longer be set by legislation. Instead, it would emerge from negotiations between lenders and borrowers or likely between lenders and schools.[19] The resulting rate would thus be both the borrower's rate and the lender's yield. Loans would still be federally guaranteed, and lenders would face no limitations on the amount of loans they could originate and hold. Under this model, some borrowers might pay a higher interest rate. Possible variations could limit the potential effects on disparate groups of borrowers. For example, one alternative would place a limit on the maximum range of rates or fees a lender could offer.[20] Another possibility would be for the government to provide subsidies to borrowers who cannot otherwise obtain low interest rates from lenders.

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[18] For instance, volume for 2-year and 4-year schools, or public, nonprofit private, and proprietary schools, could be offered in separate auctions.

[19] Lenders would be likely to assume that enough common characteristics exist across borrowers at a school to enable them to give the same rate to all a school's borrowers rather than to try to negotiate with each borrower.

[20] This would be similar to a limit that exists in the Federal Housing Administration (FHA) insurance program. FHA limits the variation between the highest and lowest "mortgage charge rates" (analogous to FFELP origination fees) that a lender may offer to any borrower within a given time period to no more than 2 percentage points within well-defined markets, as defined by geographic region and "risk characteristics," among other factors.

The models we discuss might or might not be accompanied by changes in the role of guaranty agencies in FFELP. To analyze such changes, the models would have to be specified in more detail than is possible in this report. For this reason, we do not discuss possible changes in guaranty agencies' role.

The models we discuss may present budgetary issues. The Credit Reform Act of 1990 changed the budget treatment of federal credit programs to put the scoring of direct and guaranteed loans on an equal footing. Under credit reform, loan program budget estimates for a given fiscal year reflect the estimated long-term cost to the government when the loan is disbursed. The cost to the government is the net present value of all cash flows to and from the government, including loan disbursements, repayments of principal, interest payments, recoveries or proceeds of asset sales, and payments by the government to cover defaults, interest subsidies, origination and other fees, penalties, and recoveries. (Federal administrative costs are excluded from these calculations.) For the student loan programs, Education generates these estimates for the administration using a governmentwide credit subsidy model developed by OMB. Projected program cash flows for the life of each loan cohort are generated by an Education model and discounted by an OMB credit subsidy model using a discount rate based on Treasury instruments with a maturity comparable to that of the underlying loans. For the student loan programs, this comparable maturity rate is the 10 to 20 year bond rate. Shifts in the timing of payments and receipts would need to be considered within the context of credit reform requirements. To analyze such changes, or "score" the proposals for budgetary purposes, would require more detailed specifications than is possible in this report. For this reason, we do not calculate or compare the budgetary costs of models we present in this report.

CHAPTER 2

ADJUSTMENTS TO THE CURRENT FFELP SYSTEM

The proposals to adjust the current FFELP system focus on lenders' sensitivity to interest rates, secondary market trends, and lender costs. Whether or not the Congress maintains its legislative authority to set the lender yield, each of these adjustments would modify the process, making FFELP a system more responsive to student loan market conditions. Each of the four proposals would preserve the existing relationships between borrowers, schools, lenders, and other FFELP participants, while relying on the acquisition of new or better information to adjust lender yields. Current options for borrowers to consolidate loans would continue to be available under these proposals. These proposals would affect lender yields similarly to the proposals discussed in other chapters. However, the proposals discussed in this chapter might take longer to affect lender yields than would the proposals we discuss elsewhere in this report. Each adjustment to the current system could reduce federal costs but possibly at the expense of discounts that lenders currently offer to some borrowers. The extent to which each proposal can realize these savings depends on choices regarding design and implementation.

DESCRIPTION OF MODEL AND VARIATIONS

Each of the proposals maintains the structure of FFELP while changing the mechanism for determining lender yield. The proposed adjustments to the system include

incremental adjustments proposal,
cost of funds proposal,
proposed blue-ribbon commission that would set lender yields, and
loan transaction proposal that would use data from secondary market transactions to improve the yield-setting process.

Incremental Adjustments

Under the incremental adjustments proposal, the Congress would reduce the lender yield incrementally, either annually or as needed, while carefully monitoring lender participation after each adjustment. If such a reduction in lender yield caused lender participation to drop to a dangerously low level or caused an erosion of service quality, the Congress could raise the lender yield until it believed that lender participation and service quality were once again at acceptable levels. Legislation would be necessary for each adjustment, as it is in today's program, unless the Congress specifically delegated the rate-setting role to an executive agency or to an independent government commission.

Cost of Funds

The cost of funds proposal relies on lenders' cost data to determine lender yield. Data on lenders' costs would include the actual expense to lenders associated with raising funds, loan origination, and loan holding, as well as an estimation of servicing costs deemed reasonable to maintain high-quality service to borrowers. On the basis of these factors, the Congress could determine an appropriate differential between the cost of funds and the cost of servicing. This differential could be applied to the determination of a market-based lender yield. The Congress, an executive agency, or an independent government commission could administer the cost of funds approach.

Blue-Ribbon Commission

There are two distinct ways in which a blue-ribbon commission could be organized. It could be an advisory commission whose members could include expert staff from the executive branch, representatives from the student loan or banking industries, and recognized authorities on higher education finance. This type of commission could consider the costs of funds, loan transaction cost, or other similar information. The commission could also, for example, recommend different methods for paying or calculating special allowance payments. The Congress would retain responsibility for setting the rate and could accept or reject the commission's recommendation as it saw fit. Alternatively, the Congress could establish the commission as an executive branch agency or as an independent federal entity and could give it the responsibility of determining the lender yield.

Loan Transaction Information

This proposal would use data from loan transactions to gauge the underlying value that participating FFELP lenders place on loans. The government would collect information on the terms and conditions of secondary market transactions in the existing FFELP. This information could serve as the basis for a modified determination of lender yield.

Another component of this proposal is its modification of the SAP that lenders receive. Under this plan, the SAP would be made to the loan holder only once, either when the loan was initiated or when and if consolidation or refinancing occurred, rather than quarterly as in the current FFELP. The proposal empowers an executive agency or an independent commission to establish this single supplemental payment for loans made each year rather than having the Congress continue to legislate the SAP. The amount of the single supplemental payment would be influenced by data gathered from transactions in the secondary market. Additionally, the amount of a modified SAP could vary according to lender size, student loan activity, type of loan or type of school, or any other characteristics deemed relevant.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Each of the proposed adjustments to the current system could potentially reduce or increase the federal operating costs of FFELP. Further, each of these proposals makes two assumptions regarding the current FFELP: (1) lenders' participation in the student loan program is contingent on profit sustainability, and (2) the current lender yield results in profits beyond those necessary to maintain sufficient active lender participation. These assumptions, and the corresponding reforms these proposals envision, drive the cost and savings effects for program participants, potentially saving money for the taxpayers.

If the lender yield is lowered incrementally and lender participation is maintained, the action might cost lenders a portion of their profits while saving the government some of what it otherwise would have spent on payments to lenders. As lender yield is reduced, profits for participating lenders could fall and lenders could begin to leave the program. Smaller lenders (those with low volume or high cost) would likely be the first to exit the program. However, remaining lenders might be likely to make up for this loss by acquiring the assets of the outgoing firms or simply by increasing lending activity. Thus, remaining lenders would grow larger, further concentrating the market. Larger lenders, able to operate at a lower cost per dollar of loan originated, might pass savings on to borrowers or might make improvements to service delivery.

Like the incremental adjustments proposal, the cost of funds approach could result in either costs or savings to the federal government and program participants. The cost of funds approach calls for a mechanism by which lenders can detail and report their costs and the government can form objective judgments to analyze and justify these estimates. Although some savings might be realized through reduced federal payments to lenders, this proposal would impose additional administrative costs on the federal government because cost data are not readily available. If these figures were accessible, the government could assess cost data by using a number of criteria. These could include the types of students or schools served.

An additional question is the role that the government should have in determining the accuracy of cost estimates under this proposal. The outcome of these decisions directly affects both the federal administrative cost of implementing the model and the federal payments to lenders in the program. If, for example, lenders document substantial costs for raising funds and the government accepts these figures, then the lender yield could rise, increasing the government's cost. In contrast, if the government chooses to contest these figures, it may become embroiled in a political and controversial investigation that could stall FFELP loan delivery.

The use of loan transaction information could result in decreased costs for the taxpayer. For example, while the federal government would incur some costs associated with the pursuit and analysis of information regarding secondary market loan sales, these costs might be small compared to any potential savings from reduced payments to lenders.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND SERVICE QUALITY

The adjustments to the current system would be likely to affect the current FFELP structure less than the models discussed in other chapters. These proposals could preserve or possibly improve the quality of loan service. There is consensus among the study group members that FFELP lenders have responded to the competitive pressure introduced by FDLP.

The incremental adjustments proposal might reduce the number of lenders in the program. For example, the adjustment process might initially set the lender yield so low that it would force out lenders with high costs or low volume. If these lenders leave the program, they may find re-entry costs prohibitively high should the yield be raised in a subsequent adjustment. Determining what number of lenders is sufficient is a value-laden assessment. Mergers and acquisitions resulting in fewer lenders but the same loan volume and more efficient service provision may be desirable. However, a decline in lender participation might reduce loan availability or disrupt services to students and schools.

The cost of funds proposal relies more heavily on lender information to set the lender yield by considering lenders' operating costs as a component of the yield determination. Thus, the cost of funds proposal has the potential to improve the quality of service that lenders provide. If lenders recognize that the yield will reflect their funding costs as well as their service costs, they may have the incentive to reduce costs for borrowers or to enhance service delivery by purchasing or developing new technology. While these actions would have clear benefit to borrowers, higher lender costs would force the government to increase the yield, raising federal FFELP costs.

Merely establishing a blue-ribbon commission would not affect lender participation, loan availability, or lender diversity. Establishing a blue-ribbon commission is a procedural reform, and commissioning an independent entity alone to implement adjustments to FFELP would do little to alter the provision of loans or the quality of service. Consequently, the extent to which loan availability, service quality, or lender diversity would change hinges on the rate-setting strategy the commission chose to employ.

The implementation of the loan transaction proposal relies on lender-provided information. This proposal requires the government to collect secondary market sales data. According to Education, this new data collection would impose additional reporting burdens on lenders, but the extent is unclear.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Each proposal presents logistical and regulatory challenges to the Congress. The incremental adjustments approach calls for carefully monitoring lender activity, while the cost of funds proposal represents a shift toward oversight and evaluation of lender operations. Lenders' potential unwillingness to release cost information, as well as the difficulty inherent in analyzing it, would present challenges to implementing this proposal. While the blue-ribbon commission approach aims to remove rate setting from the congressional arena, the extent to which an independent entity could effectively oversee a program of this size remains unknown. Although a blue-ribbon commission might be empowered to set the yield, it would be subject to administrative requirements that might leave it open to the same budget and political pressures that the Congress faces. Finally, collecting data from loan sale transactions might complicate FFELP administration, requiring the government to track the prices associated with secondary market loan sales. Since lender yield would still have to be set by the Congress or some other entity under each approach rather than emerging from a market process, the rate-setting mechanism still might not be free from the political process. Any of these approaches could result in either more or less regulation, while all would impose new administrative burdens.

The incremental adjustments proposal could entail additional regulatory burden for FFELP. Specifically, the incremental adjustments proposal would require carefully monitoring lender response each time an adjustment was made. The need for timely information and for prompt action to counteract excessive adjustments requires special considerations. Some mechanism would be required to halt further downward adjustments from negative consequences such as lender departure. In addition to regulatory burden, this proposal could create significant administrative burden. If this proposal were to be implemented, it might require delegation to an independent entity such as the blue-ribbon commission. In any case, some entity would have to monitor the program and make recommendations as to further changes.

Concerns exist regarding the implementation of the cost of funds proposal as well. Administering a cost of funds model would introduce additional data collection needs. This proposal requires the annual development of two sets of proprietary lender information (costs of raising funds and an estimation of servicing expenditures) for use in setting lender yield. Collecting and verifying lender cost information could present new challenges. The data collection process itself might be impeded by the complexity of lender transactions (such as securitizations and forward purchase agreements) and by the variation in lender structure (free-standing, part of a holding company whose main focus is student loans, part of a larger bank for which student loans may be a small business). Inaccurate and inadequate data would limit the government's ability to manage this program. The proposal would also require the subsequent modification of lender yield if lender cost data indicated that the current rate were inappropriate. Some of these assessments, however, require normative judgments about the degree to which costs should vary by the types of schools and students lenders serve.

Many of these challenges to simplicity and regulatory burden apply also to the blue-ribbon commission proposal. Panel selection might become politicized and controversial. Additionally, while establishing the commission would reduce the direct congressional role in setting yield, it remains unclear whether the commission would be advisory or authoritative, how the panel would access data, and whether consensus would be required for commission decisions. The commission would need authority to gather relevant data as well as the resources to analyze them. Implementation decisions would also center on the type of legislation necessary to establish the commission's tasks and objectives and on the delegation of congressional staffers for administrative and substantive assistance.

The blue-ribbon commission might or might not remove the setting of the lender yield from the political process. If the commission were advisory, then the Congress would still be responsible for setting the rate and could still face political pressure from FFELP participants who disagreed with its recommendation. If the commission were a federal agency, then the Congress would not face such pressure directly but the commission might. Political pressure on the commission's decision could be especially great if the Congress required it to publish a public notice of its proposed decision and respond to public comments on its proposal before implementing it. The Congress has imposed such a requirement on most federal agency rulemaking decisions. If the Congress decided to exempt the commission from this requirement, then the commission would be less subject to political pressure but would also be less accountable to the public and might lose the benefit of information that public comments could provide.

One federal agency that functions like a blue-ribbon commission is the Postal Rate Commission (PRC). PRC is an independent executive agency that recommends postal rates to the U.S. Postal Service's board of governors. When the Postal Service requests a rate change, it must provide PRC with data about the relevant costs. Before making a rate recommendation, PRC must hold public hearings, which include testimony and written submissions from the Postal Service, its competitors, and others that are interested. In making a recommendation, PRC must consider nine legislatively established criteria as well as the record of its hearings. The postal ratemaking process is lengthy and complicated. There is a process for modifying or rejecting PRC recommendations, but those recommendations have usually been accepted without modification.

The loan transaction information proposal requires the government to monitor lender participation and corresponding secondary market transactions. However, collecting and verifying private secondary market transaction information might present challenges, especially considering the proprietary nature of agreements between secondary market participants. Carefully monitoring the secondary market will demand administrative oversight, forcing decisions about what information will be gathered and how it will be analyzed.

The federal government, or its designated blue-ribbon commission, could periodically auction a limited amount of direct loans as an alternative source of secondary market information. Existing law authorizes sales of direct loans. However, selling a portion of the FDLP portfolio could present budgetary challenges. Under federal credit reform, such sales could possibly be recorded as a loss, which would require offsets under current budget rules. Other ways to offset the subsidy cost of selling direct loans would be to securitize some of the FDLP loans in Education's portfolio.

Finally, implementing an auction of FDLP loans could increase administrative burden. Insufficient competition could threaten the integrity of the bidding process. It would also involve decisions on who would facilitate the auction and how competition would be preserved. Auction design issues and the importance of competition are discussed in detail in appendix III. The results of the analysis for the adjustments to the current system are summarized at a broad level in table 9.

Table 9: Summary of Analysis for Adjustments to the Current System Model

Description of model, including variations	All proposals maintain current roles and relationships for FFELP participants. Proposals use information from the marketplace—for example, data on lenders' cost of funds or secondary market sales—to set the yield level. Might involve establishing a blue-ribbon commission to either set the yield or recommend a yield level to the Congress.
Costs, savings, and effects on subsidies for program participants	Federal FFELP costs could increase or decrease but are more likely to decrease. Savings to the taxpayer, if any, could come at the expense of some discounts that lenders currently offer to some borrowers.
Effects on lender participation, loan availability, and service quality	Loan availability should not be greatly affected if adjustments are incremental. The number of lenders in the program could fall if adjustments force out lenders with low volume or high cost. Service quality would be subject to the same pressures.
Simplicity, regulatory burden, and program integrity	Relationships between FFELP participants would change little. Oversight of lender operations, and required data gathering and analysis, might prove difficult. Blue-ribbon commission would require administrative framework.

CHAPTER 3

LOAN ORIGINATION RIGHTS AUCTION

The origination rights auction model would require lenders to bid for the right to originate and obligate them to lend FFELP loans. Auctions rather than the legislative process would set the yield that lenders would receive. If the auctions were sufficiently competitive, bidding would eliminate any excess in what the government currently pays lenders and would maintain lender incentives to reduce their costs. Therefore, auctions have the potential to reduce federal FFELP costs. The effects of auctions on borrower interest rates, the distribution of federal payments to lenders, the quality of service, and the burden on borrowers and schools are uncertain. The effects depend on the details of auction design as well as on a number of assumptions about markets that may or may not be valid in relation to the student loan program. The diversity of lenders would likely decline unless special provisions were made to ensure the participation of small lenders. Students' and parents' access to loans could be reduced during the transition to auctions and, depending on auction design details, perhaps permanently. The federal government would have to develop new regulations to govern the conduct of the auctions and, in particular, to preserve competition in bidding. Students, lenders, and schools would all bear the burden of adjusting to the auction system.

DESCRIPTION OF MODEL, INCLUDING VARIATIONS

In origination rights auctions, lenders would bid for the right to originate student loans. The federal government would develop regulations to implement the auctions and would maintain its current subsidies to borrowers. Major choices that must be made in designing the auctions include

whether the auctioned rights are rights to originate all loans at particular schools or groups of schools or rights to originate a specified volume of loans at any of a number of schools,
whether origination rights or volumes are grouped by school,
whether each student borrower is allowed to keep all loans with a single lender, and
which bidding method is used, including whether lenders bid on the interest rate they would receive on loans they originated or on the price they pay to originate loans at a predetermined interest rate.

Basic Model and Role of Participants

All versions of the origination rights auction model share several features. The borrower's maximum interest rate, in-school subsidy policy, and some other loan terms would be set through federal legislation or regulation, as at present. Lenders would bid for the right to originate loans. They would indicate the prices that they were willing to pay or the interest rates they were willing to accept for the right to originate at particular schools or to originate a specified loan volume. In each auction, a lender could submit a single bid or multiple bids that incorporated different prices or interest rates. The government would sort bids by price or interest rate, and the most favorable bids would win the right to originate. It would be possible to set aside some origination rights for nonbidders. However, most rights would be determined through the bidding process. Lenders who submitted winning bids would be allowed to originate only at the schools where they won rights or to originate only the volume they won. Except for nonbidders who received set-asides, nonwinning lenders would not be permitted to originate loans. Lenders could buy and sell origination rights after the auction but before loans were originated. They could also buy and sell loans after origination, as they do today.

The federal government could be responsible for conducting the auctions and ensuring borrowers access to loans. The government would determine whether lenders were eligible to participate in FFELP. Education might also act as a loan consolidator, as in the current FDLP. It might need to establish procedures to ensure that eligible borrowers received loans and that winning lenders performed as promised. The government would also need to establish procedures to ensure access to loans when loan demand exceeded auctioned loan volume. In addition, it might need to re-auction loan origination rights for lenders who could not or would not perform as promised, although it would be possible instead for these rights to be resold in the secondary market. During the transition from the current system of setting FFELP lender yield to an auction system, the government would have to develop new regulations to govern the conduct of auctions, develop the expertise to conduct auctions itself or contract with a nongovernment entity to conduct the auctions, educate lenders and borrowers about auctions, and act as lender of last resort to ensure that all eligible borrowers have uninterrupted access to loans. No state role is envisioned beyond the one that now exists in FFELP.

Major Variations on the Model

Several high-level decisions must be made in designing an origination rights auction model. The items to be auctioned could be either the rights to originate all loans at particular schools or groups of schools or the rights to originate a specified volume of loans at any of a number of schools. Origination rights or volumes may or may not be grouped by school. The right to lend includes the obligation to lend. A variety of bidding methods could be used. Finally, each student borrower may or may not be allowed to keep all loans with a single lender.

The study group considered three alternative designs for an origination rights auction. In the "rights auction," lenders would bid for the right to originate all loans at a particular school or group of schools. In the "volume procurement" design, lenders would bid for a specified loan volume that could be used at any school and either all winning lenders would pay the same price or each would pay the price it bid. The Income Dependent Education Assistance (IDEA) version resembles volume procurement, except that each winning bidder would pay the price bid by the next highest bidder and there would be an explicit ICR provision. These three proposals illustrate but do not exhaust the range of available alternatives. Other combinations of auction characteristics are possible. For example, the right to originate at specific schools could be combined with each winner's paying the next highest bid price. Any origination rights auction could either include or exclude income-contingent repayment.

The three versions of the model illustrate a fundamental choice that must be made in the design of an origination rights auction. In the rights auction version, lenders bid on the right to originate loans to students at a particular school or group of schools. In the volume procurement and IDEA versions, they bid on a specified volume of loans, which they can lend to students at any of a number of schools.

Under any alternative, schools may or may not be grouped together when origination rights are auctioned. In rights auctions, grouping would mean that lenders would bid for the right to originate at particular groups of schools. In volume procurement, it would mean that lenders would bid on a volume of loans that they could use only at particular groups of schools. Under either alternative, the rights to originate at all groups of schools could be sold at the same auction, or else a separate auction could be held for each group. At the opposite extreme, the government could decide not to group schools but to require lenders to bid for the right to make loans to all FFELP-eligible students, regardless of school.

A variety of bidding methods could be used. One important issue is whether lenders would bid on the interest rate they would receive on loans they originated or on the price they would pay to originate loans at a predetermined interest rate. If lenders bid on an interest rate, then that rate would likely be expressed as a markup over a reference rate that bears some relationship to lenders' cost of funds, such as a T-bill rate or the CP rate. If lenders bid on a price, then their bids might or might not be allowed to be negative. (A negative bid would be one in which the lender asked the federal government to pay it a specified price in order to make it willing to lend.) Issues related to auctions, including the grouping of schools and the choice of bidding method, are discussed further in appendix III.

A final important design choice is whether to allow each borrower to borrow from a single lender, at least for the duration of a particular degree program. For example, a student entering an undergraduate program could be given the right to borrow from one lender until he or she completed that program, even if that lender did not win the right to originate at that student's school for all the years in which the student was enrolled in that program. Alternatively, a student could be required to switch lenders whenever his or her previous lender lost the right to originate at his or her school.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Auctions have the potential to reduce federal FFELP costs, but their ability to realize this potential depends on whether there is sufficient competition in bidding. The frequency with which auctions were held, the definition of auctionable rights, and the choice of bidding method could also affect federal costs. The distribution of federal payments to lenders would be more uneven in some types of auctions and unchanged in others. Auctions could reduce all borrowers' interest rates, raise some borrowers' rates, or leave all borrowers' rates unchanged.

In an ideally competitive auction, bidding competition among lenders would eliminate any excess profits that lenders would otherwise receive. The bidding process would ensure each lender just enough profit to make that lender willing to remain in FFELP. Furthermore, the winning lenders would be the ones with the lowest loan origination costs. Appendix III describes an ideally competitive auction, explains how such an auction would produce these results, and shows how the less-than-ideal auctions that would be likely could produce most of the same results.

Regardless of whether lenders currently receive excess profits, lenders might reduce their costs by developing less expensive methods of originating loans to secure volume by lower bids. Lower bids would mean reduced federal payments to lenders. However, origination rights auctions will only reduce federal FFELP costs if there is sufficient competition among lenders. Whether the student loan origination market at present is sufficiently competitive for origination rights auctions to reduce federal costs is unclear.

Evidence from other federal auction programs suggests that origination rights auctions could produce savings, which could be retained by the federal government or passed on to the borrower. In the Health Education Assistance Loan (HEAL) program, under which lenders bid for the right to originate student loans to students of the health professions, the federal government kept the volume artificially low by capping loan volume. This resulted in a drop in the spread over T-bills from 3 percent in 1993 to 1.5 percent in 1997.[21] The Federal Communications Commission's (FCC) auctions of wireless spectra have yielded revenues exceeding their costs, but these auctions took several months on some occasions, and auctions on certain spectra had to be recompeted because of the lack of competition.

The current student loan market, however, may not be competitive enough to enable origination rights auctions to produce savings for the federal government. As chapter 1 showed, a limited number of large lenders hold a large share of loans in the student loan market; furthermore, it may be costly for new lenders to enter the market. If the limited number of lenders is the result of natural scale economies, the associated cost savings have the potential to benefit all participants. If the limited number of lenders results in less competition and excess lender profits, this market structure is undesirable, with or without auction mechanisms, and is best addressed by our nation's laws regarding monopolistic practices. In either case, because the number of lenders is limited, the dominant lenders' influence on the winning bids could conceivably lead to FFELP costs that were as high as or higher than current costs. Some believe that lenders might also collude in setting their bids. The relatively small number of lenders in the market would make collusion easier.

FCC's wireless spectrum auctions illustrate this problem and some solutions to it. In some FCC auctions, bidders were able to signal their bidding strategies to other bidders by using the last three digits of the amount bid or by strategically withdrawing from the bidding. FCC corrected the former problem by setting minimum bid increments that bidders were required to use in raising bids. It solved the latter problem by limiting the number of withdrawals a bidder was allowed to make during an auction.

A competitive secondary market in loan origination rights could at least partially compensate for insufficiently competitive auctions. Such a market, which does not now exist, would enable lenders to buy and sell rights to originate student loans outside the auctions and would add a new layer of complexity to the program.[22] The Environmental Protection Agency (EPA) sulfur dioxide emission allowance auctions provide an example. Allowances sold at those auctions have been concentrated in the hands of a relatively few firms. However, the secondary market, on which allowances are traded outside auction, is much larger than the auction market. After the first few years of EPA auctions, the secondary market, rather than the auctions, appears to have determined the price of allowances. Because the auction price reflected the secondary market price, insufficient competition in the auction might have been less of a problem than it would have been in the absence of a secondary market.[23]

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[21] In contrast to FFELP or FDLP, the HEAL program never exceeded more than $500 million in insurance authority for a single year. The experiences under the HEAL program may or may not indicate the potential for savings through the adoption of an auction mechanism in a larger program.

Although sufficiently competitive auctions could reduce federal payments to lenders, their overall effect on FFELP costs would also depend on details of the auction design. The frequency with which auctions were held, the definition of auctionable rights, and the choice of bidding method could influence FFELP costs. They could do so by affecting either federal payments to lenders or the cost of conducting auctions.

At present, all lenders receive a uniform federal payment equal to the difference between the lender yield and the maximum borrower interest rate, both set by law. Some types of origination rights or volume procurement auctions would lead to an unequal distribution of federal payments to lenders, while others would not change the current pattern of equal payments to all lenders. Both the choice of bidding method and the grouping of schools would affect the distribution of federal payments to lenders. A full discussion of competition, auction design and frequency, bidding methods, and the grouping of schools is in appendix III.

In addition, if borrowers do not have the option of borrowing from a single lender until they complete their education program, these proposals could increase the attractiveness of consolidation to borrowers. If lenders expect the use of consolidation to increase, they will bid less, and federal revenues from the FFELP auctions could decline.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND SERVICE QUALITY

Auctions could either reduce the quality of service or have no effect on it. In the absence of special provisions, they could reduce the diversity of lenders. The definition of auctionable rights, the choice of bidding method, and the frequency with which auctions were held could affect borrower and lender access to FFELP as well as the quality of service. Some students and parents could have difficulty obtaining loans during the transition to an origination rights auction. Some transitional challenges might be anticipated and thus minimized through the use of a pilot auction program, although results from a pilot might be difficult to interpret if participating lenders are uncertain as to the likelihood of the program's continuation.

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[22] A secondary market in origination rights would differ from the existing secondary market, in which loans are bought and sold after they have been originated.

[23] FCC and EPA auction models are dissimilar in many ways from a loan origination rights auction. For example, end users of wireless spectrum communication often have readily available alternatives and thus are not likely to suffer if an auction winner does not provide such service. Further, consumers may actually benefit if the holders of emission rights are not exercised. Caution is necessary in using these auctions as models for an origination rights auction.

Auctions may or may not reduce service quality but are unlikely to improve it. The number of lenders permitted to serve each school, the frequency with which auctions were held, and the method by which bids were evaluated could also affect service quality.

Auctions might shift the balance of competition in the student loan market toward price competition and away from service competition. At present, FFELP lenders compete to a limited extent on the basis of price, through discounts to preferred borrowers. They also compete on the basis of service. Auctions would force lenders to place more emphasis on price competition, since the major (and, in most variants, the sole) criterion for determining auction winners would be the price or interest rate bid. It is possible, although not certain, that lenders would pay less attention to service as they paid more attention to price.

Service quality could be higher if multiple lenders were allowed to serve each school than if there were only one lender per school. If more than one auction winner could serve each school, then students could choose among lenders. Lenders would have an incentive to compete for students on the basis of service quality. This incentive would not exist if only one lender could win the right to serve each school.

Finally, service quality could be improved if the government were allowed or required to take service quality into account in choosing auction winners, but there are important drawbacks to this. One option would be to evaluate bids on the basis of service quality as well as price or interest rate. Another would be to prequalify bidders using service quality criteria and then conduct the auction on the basis of price or interest rate alone. These procedures would make auctions more complex than if bids were evaluated solely on the basis of price or interest rate. The added complexity could deter small lenders from participating in FFELP. Loans that had service quality features as legally enforceable terms would also be more difficult to sell in the secondary market than loans without such features.

Auctions could increase, decrease, or have no effect on lender diversity in the short term but might reduce it in the long term.[24] Provisions to protect small bidders' access to FFELP could be built into the auction design. Small-bidder protections may make auctions more competitive as well as ensure small lenders' participation in FFELP. The choice of bidding method, the number of lenders allowed to originate at each school, and the frequency with which auctions were held could also affect lender diversity.

In the short term, auctions may have any of several effects on the number of FFELP lenders. They may increase lender participation by enabling new lenders to enter the market on relatively equal terms with existing lenders. Or they may have no effect on participation if entry into the origination market is so expensive that no new lenders are willing to enter. It is also possible that auctions would increase large lenders' dominance of FFELP market. Large lenders would have several advantages over small lenders in origination rights auctions. Because they can usually obtain loan funds more cheaply and spread their costs over a larger volume of loans, large lenders would generally be able to outbid their smaller competitors. In addition, auctions would necessarily make lenders uncertain about their prospects of continuing to participate in FFELP. This uncertainty may be more likely to deter small lenders than it would be to deter large lenders. In the long term, it is possible that auctions would gradually reduce the number of lenders, although we do not know how likely this outcome is. Lenders who did not win origination rights in one auction might leave FFELP permanently because it might be expensive to re-enter the origination market. If losing bidders dropped out permanently after each auction, then the number of bidders would gradually decline. Only a few large lenders might be left to originate student loans.

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[24] As we showed in chapter 1, the student loan industry is highly concentrated and is becoming more concentrated. If the trend toward reduced competition in the industry were expected to continue regardless of FFELP rules, then auctions' effects on lender diversity would have to be evaluated relative to this trend.

Evidence from the HEAL program neither clearly supports nor clearly refutes this argument. The number of HEAL bidders declined during the last 4 years of the program.[25] (These are the only years for which we were able to obtain comparable data.) However, this decline may have stemmed from lenders withdrawing from the auctions after the Congress decided to end the program. Moreover, the number of lenders receiving loan origination rights did not fall continuously. There were four or five large HEAL lenders in the last few years of the program until the very last year. Furthermore, lenders entered and re-entered rather than dropping out permanently after losing at auction.

Small-bidder protection measures and the choice of bidding method could affect the diversity of lenders. Auctions can be designed to enhance small bidders' ability to compete. More lenders might participate in auctions if all auction winners paid the same price than if each paid a different price. Lender participation might also be greater in an auction with multiple rounds of bidding than in one with a single round. However, a single-round auction might be more attractive to small lenders because it would be simpler than a multiple-round auction. Lender diversity would probably be greater if more than one lender were allowed to originate at each school than if there were only a single lender per school. More lenders would be likely to participate in FFELP if multiple lenders could serve each school. For more details on these issues, see appendix III.

An additional complication associated with the volume procurement proposal would be the challenge of estimating the annual borrowing needs of students. An underallocation of loan volume could result in delays in funding and in loan access problems for student loan providers. The Congress might want to include additional requirements to ensure that loans were available to all eligible borrowers. For example, it could require the federal government to serve as a lender of last resort or design a mechanism to increase the allocation for lenders who were approaching their allocated limit. Alternatively, the federal government could pay lenders to serve borrowers who would otherwise not receive loans. (Allowing lenders to submit negative price bids at auction—that is, requesting that the federal government pay them to serve certain groups of schools—would be one way of implementing such payments.)

Auctions should be held when borrowers can receive loans when they need them. After an auction is completed, time is needed to process bids and notify the winning lenders. The winning lenders, in turn, need time to disburse loans after they are notified. For borrowers to receive loans when they need them, all these things have to be done before the start of the school term. If there were a secondary market in origination rights, then trades on this market would also have to be timed to enable lenders to receive funds and disburse loans in time for the beginning of school. Schools' academic calendars vary widely, and academic programs can start at any time of year. Therefore, it would not be possible to link the timing of auctions to that of loan disbursements. However, it would be possible for loans to be disbursed continuously between auctions. For example, auctions could be held once every 3 to 5 years, and the winners of each auction could use the origination rights they won at any time between that auction and the next year's auction.

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[25] Most HEAL lenders were also large FFELP lenders and considered HEAL lending complementary and marginal in importance to their FFELP lending activities. Many schools found the HEAL program unsatisfactory, believing it unstable and unpredictable.

Finally, the transition to auctions could temporarily disrupt both student and parent access to FFELP loans. Lenders would require some time to become accustomed to the auction system. Some lenders might at first miss deadlines or fail to submit payments that the government might require before the auctions. Some might decide not to participate in the initial auctions. Those who did participate might not bid on as many origination rights as they would if they were more familiar with the auction process. The government might experience delays in processing bids and notifying auction winners. For all these reasons, auctions could initially reduce FFELP loan volume. The federal government could maintain student and parent access to loans during the transition period by acting as the lender of last resort or by paying private lenders to do so. In addition, the federal government could identify potential access problems during the transition by conducting an auction pilot program before implementing an auction system for all FFELP loans. Using knowledge gained from the pilot program, it could then take steps to minimize those problems.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Because insufficient competition could threaten the integrity of the bidding process, auctions would require special rules to preserve competition. The definition of auctionable rights, the choice of bidding method, and the frequency with which auctions were held could affect the simplicity and integrity of FFELP and the burden that auctions would place on lenders, students, and schools. Lenders, students, and schools would all bear the burden of adjusting to new regulations and market practices. Some transitional challenges could be anticipated and thus lessened through the use of a pilot program.

To preserve the integrity of auctions, the federal government would have to adopt and enforce regulations to maintain competition in bidding. Rules to prevent bidders from colluding would be necessary, and their nature and complexity would depend on the kinds of collusion to which a particular type of auction could be vulnerable. FCC, for example, set minimum bid increments to prevent bidders from signaling their bidding strategies by using the final digits of their bids.

Collecting the data needed to administer this program could present new challenges. Tracking the results of auctions and administering a program with origination rights auctions or volume procurement auctions requires data not currently available. At a minimum, the government would require the ability to monitor eligible lenders' loan portfolios by school and loan volume. Insufficient data would limit the government's ability to manage this program.

All auctions would require rules to ensure that bidders were able to pay the amounts they bid. Without such rules, nonserious bidders could distort competition. Other federal auctions provide examples of rules that could be adopted in an origination rights auction. EPA requires each bidder in sulfur dioxide emission allowance auctions to send a certified check or letter of credit to cover its bid before the auction. (This rule is feasible only for sealed-bid auctions, in which each bidder submits a single bid.) FCC requires bidders in its wireless spectrum auctions to submit refundable deposits to cover the cost of placing bids. A final option, not used in any federal auction, is to require all potential bidders to show some evidence of their ability to pay. One way of implementing this option is to use the current FFELP eligibility criteria as evidence of ability to pay. Another alternative is to require FFELP-eligible lenders to pass additional ability-to-pay tests before allowing them to participate in the auction.

The greater the total number of auction winners, the longer and more complex the process of determining winners is likely to be. Length and complexity will probably be greater, for example, the larger the number of groups into which schools are divided and the greater the number of winners per group or per school. The longer and more complex the bid evaluation process, the greater the burden on lenders. If lengthy and complicated bid evaluation methods caused delays in the disbursement of loans, then they could also impose burdens on borrowers.

Bidding methods differ in their simplicity, speed, and vulnerability to collusion. An auction that has a single round of bidding is faster than one with multiple rounds, and the bid evaluation process is simpler. Allowing lenders to bid on groups of schools that they define complicates the evaluation of bids. (See app. III for details.) It is simpler and faster to evaluate bids on the basis of price or interest rate alone than to include service quality criteria in the evaluation. Finally, as appendix III explains, a multiple-round auction may be more vulnerable to collusion than a single-round auction, and an auction in which each bidder pays a different price could be either more or less susceptible to collusion than one in which all bidders paid the same price.

Frequent auctions could impose substantial burdens on lenders, students, and schools. Because participating in auctions would cost lenders both money and time, more frequent auctions would be more burdensome to lenders. In addition, according to some school representatives in the study group, students and schools value the ability to deal with a single lender. Therefore, more frequent auctions could impose a greater burden on schools and students by disrupting long-term student-lender and school-lender relationships.

Any origination rights auction system would require lenders, students, and schools to adjust to new regulations and changes in the student loan market that resulted from auctions. The nature of the regulations adopted to implement auctions would depend heavily on the specifics of the auction design. However, those regulations would probably have to be very detailed, and monitoring lender compliance could be costly. Regardless of the particulars, lenders would have to learn how to participate and might be subject to new regulations to ensure their ability to use the origination rights they won. All origination rights auctions would restrict students' and schools' ability to work with the lenders of their choice, and those with a single winning lender per school would eliminate their ability to do so. Lenders, students, and schools would all have to adapt to the changes in loan availability, lender and borrower interest rates, and service quality that could result from auctions. Table 10 summarizes the analysis for the loan origination rights auction model at a broad level.

Table 10: Summary of Analysis for Loan Origination Rights Auction Model

Description of model, including variations	Lenders submit bids to originate loans. Some win right to originate and others do not. Auction could be conducted for the right to originate at specific schools or groups of schools or for a certain loan volume that could be used at any of a number of schools. Other major design options include grouping schools, choice of bidding method, whether a borrower keeps all loans with one lender.
Costs, savings, and effects on subsidies for program participants	Federal costs could lessen if competition is sufficient. Distribution of payments to lenders would be unchanged or more uneven, depending on auction type. Borrowers' interest rates could decline for all, remain unchanged for all, or increase for some.
Effects on lender participation, loan availability, and service quality	Loan origination costs could lessen if competition is sufficient. Service quality may decline or remain unchanged. Diversity of lenders is likely to decline unless auctions included small-lender protections. Schools' ability to work with preferred lenders could be reduced. Loans would not be available to all students in some types of auctions.
Simplicity, regulatory burden, and program integrity	Program integrity would require new rules to preserve competition. Burden on lenders, students, and schools would differ, depending on auction type. Lenders, students, and schools would bear the burden of adjusting to new auction regulations developed by the government.

CHAPTER 4

LOAN SALE

Under the loan sale model, the federal government, or some entity other than private lenders, would originate all student loans, and the government would later sell them at auction in a secondary market to the highest bidding lenders. Preferably, the government would elect to sell loans immediately following origination or later when the borrower enters repayment. Because the federal government would be responsible for loan origination, and the loan guarantee terms could change, the federal role in FFELP would be vastly different from today. Purchasers of the secondary market loans could include today's FFELP lenders as well as new participants, however some current lenders, including lenders who currently originate loans but subsequently do not hold them, might not choose to participate. The federal costs of the loan program could also be lower, partly because the government's lower cost of securing the funds to make loans and reduction in fee payments to guaranty agencies for services related to verifying lender eligibility. If there is sufficient competition, then the auction among secondary market participants could reduce federal FFELP costs. Secondary market concentration would be likely to increase with this mechanism, perhaps reducing the participation of small community-based lenders. Loan availability would be universal, with the federal government being the only program lender. Centralizing the loan origination and distribution functions may simplify the loan process. Schools and borrowers would deal only with the federal government or the designated entity to obtain loan aid. Adjustment to the new system could prove burdensome for some lenders.

DESCRIPTION OF THE MODEL, INCLUDING VARIATIONS

The loan sale model and variations we discuss in this chapter share several features. Generally, some entity other than private lenders would originate student loans. The terms of the loan, such as the borrower's maximum interest rate and the in-school subsidy policy, would be set through legislation, as now. Packages of student loans—with or without a guarantee—would be purchased privately at periodic sales or auctions. While the purchaser buys loans, either the purchaser or some other entity may perform the servicing functions. In each auction, a lender could submit a single bid or multiple bids that incorporated different prices. The government would sort bids by price, and the highest bids would win the right to purchase loans. The government could set a minimum price below which it would not sell any of the loans it originated. It would be possible to set aside some loan packages for nonbidders. However, most purchase rights would be determined through the bidding process. A variety of bidding methods could be used, as described in appendix III.

Proposals for this model vary as to who originates loans, how loans are grouped when they are sold, who is responsible for servicing loans, whether the loans sold are federally guaranteed, and whether payment is due in full at the completion of the loan sale. Origination could be carried out by a federal entity or by private contractors, as is in FDLP. The government could sell these loans immediately or it could hold off selling the loans until a borrower enters repayment. If the loans are sold with government servicing, the purchaser is buying the stream of payments and the government needs to contract for servicing.[26] If the loans are bundled and auctioned off without government servicing, purchasers can arrange for servicing or possibly they can retain the services of the government contract servicer. Loan bundles are less valuable if they are sold without a guarantee than if they are sold with a federal guarantee. Allowing lenders to make payments in installments could foster competitive participation in loan sales.

Several options are available for loan origination. One alternative would be to give a government entity (such as a new government-sponsored enterprise) the authority to originate federally guaranteed student loans. The government could maintain the origination procedures in place for FDLP, using private contractors to originate loans. Another option would be for the government to require the student-lending industry to charter a mutually owned corporation that would originate and provide short-term funding of loans. The objective would be to structure the entity's ownership and transactions to give it an incentive to keep down its costs. Achieving that objective could be difficult without competition, however.

Loans from particular groups of schools may or may not be bundled together when loans are auctioned. Grouping by schools would mean that lenders would bid for packages of loans that were originated at particular groups of schools. The loans from each grouping of schools could be sold at the same auction, or else a separate auction could be held for each group. In defining groups of schools, several alternatives are possible. An Internet-accessible interface could inform potential purchasers of the characteristics of loans bundled as a package. Issues related to the grouping of schools at auctions are presented in appendix III.

There are several options for servicing loans after they are sold at auction. One would be that the government could keep the responsibility of servicing loans that were later sold at auction. This could possibly increase auction proceeds by attracting bidders who do not have servicing capacity but are interested in receiving interest income and loan principal. Auction proceeds would also vary, depending on whether the lenders expect the government's servicing to be more or less costly than other servicing options. If the purchaser services loans, combining the loans of all borrowers reduces the burden on each borrower. Some provisions would need to be made for loan consolidation and loan deferment. Either the government or the private lender could consolidate the loans if the borrowers return to school.

Another issue is whether the loans or securities are sold with federal guarantee. If the loans are sold with a guarantee, then the guarantee could be set at the current 98 percent of principal or it could be set higher or lower. The government would have to decide on the extent of the guarantee and would have to define the conditions under which the guarantee applies, such as death or bankruptcy. One variation is to have no explicit federal guarantee or due diligence requirements. In another variation, lenders could have the right to resell the loans to Education in the event of death, disability, bankruptcy, or the borrower's election of ICR. Other variations assume that federal loan guarantees continue, as with the current program.

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[26] A variation on loan sales with government servicing is selling securities backed by student loans. Securitization is the process of selling debt securities to investors with groups of loans serving as collateral for the debt.

One variation would allow lenders to pay for bundled loans in installments. Installment financing arrangements could be tied to the loan payment revenues received by the purchasing lender or to a fixed repayment schedule, and the appropriate interest rate would have to be determined. Either arrangement reduces the initial funds needed to purchase loan bundles, thereby potentially increasing lender participation.

Treasury developed an additional variation of this model and presented an outline of it to the study group. The study group did not review this and this outline is reproduced in appendix V.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Loan sales could potentially raise enough revenue to reduce overall federal FFELP costs, but their ability to realize this potential depends on sufficient competition in secondary market bidding. The federal government (or some entity acting on its behalf) will originate all loans, taking advantage of the government's ability to raise funds at a lower interest rate. The grouping of loans into packages, the choice of bidding method, and the frequency of auctions could also affect federal costs. If competition prevails, there could be a lower net lender yield. However, insufficient competition could threaten the integrity of the bidding process. Auctions are not likely to affect borrower costs. However, schools participating in FFELP could incur costs in implementing a new delivery system.

Reduced federal costs could result from eliminating federal payments to originating lenders and financing loans with low-cost Treasury financing. Removing originating lenders would eliminate their current federal SAP as well as the need to pay private lenders the in-school interest subsidy. Separating loan origination from the rest of the student loan process might enable the federal government to take advantage of any savings because of greater specialization in student loan origination. An entity responsible solely for student loan origination would not have to be concerned with raising necessary funds competitively or with servicing loans efficiently. However, removing competition from loan origination could eliminate incentives to continuously improve the efficiency of the origination process.

Further federal savings could accrue if loan sales foster competition in the secondary market for loans, but savings would depend in part on auction design decisions. Ideally, competitive bidding for loans among secondary market lenders would result in loans being held and serviced by those with the lowest cost of funds and the most cost efficient at servicing loans. Increasing concentration in the existing secondary market for student loans raises questions about the extent to which competition will operate in loan sales and the extent to which potential cost savings will accrue to the federal government. If auctions are not sufficiently competitive, then increased lender net yield could result, potentially reducing federal revenues from the sales and thereby increasing federal FFELP costs. Although sufficiently competitive auctions could reduce net lender yield, their overall effect on FFELP costs would also depend on the details of the auction design. Auction frequency, the choice of bidding method, and the definition and grouping of auctionable packages could either lower or increase FFELP costs.

The terms of sale affect the price that bidders pay for loans in an auction. Lenders bid more for loans that are sold with a guarantee.[27] The net effect on federal costs would then depend on a comparison of the additional revenue raised by guaranteeing loans to the federal cost of providing a guarantee. Also, federal costs could depend on whether winning bids are payable in full immediately after the close of the auction or whether a schedule of installment payments is allowed. Allowing installment payments extends federal funding to secondary market participants, possibly enabling small bidders to participate more easily. Small bidders would have to come up only with a down payment rather than with the full purchase price, enabling bidders with less funding to compete with better-funded large bidders. However, allowing loan purchasers to pay in installments could result in new risks and potential costs. The most significant of these risks would be that lenders obtaining federal funding might be unable to repay the money they borrow from the government. Several considerations might mitigate this risk. For example, lenders could be made to meet additional criteria, related to financial soundness and creditworthiness, before being allowed to borrow from the federal government. In addition, legislation or regulation could treat the auctioned loans as collateral for the borrowing. The cost of administering an installment payment option would be an additional source of increased federal government costs for FFELP.

Ultimately, borrower costs are unlikely to change much after the sale of loans at auction is implemented. Some lenders now offer origination fee or interest rate discounts off of the maximum rate to some borrowers (for example, those who attend schools with low default rates). If lenders are providing discounts from profits, then auctions could eliminate the discounts by reducing those profits. As a result, some borrowers who now receive discounts may no longer receive them. However, if discounts do not come from lenders' profits, then auctions would not eliminate the discounts and would have no effect on borrowers. Furthermore, if auctions reduced federal FFELP costs, the Congress could decide to pass those savings on to borrowers by lowering the maximum borrower interest rate. In that event, all borrowers would benefit from lower interest rates. Other discounts that loanholders currently provide occur after the loan has entered repayment. Lenders have provided these discounts for automatic electronic payment and demonstrated timely payment experience. Loan holders will continue to have an incentive to encourage timely or electronic repayments which result in lower costs by offering discounts. Issues related to competition, auction frequency, auction design, bidding methods, grouping, and payment methods are presented in detail in appendix III.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND SERVICE QUALITY

With loan sales, the federal government or some entity other than private lenders would originate all student loans. Loans would be universally available to all eligible borrowers. Concentration in the secondary market would be likely to continue to increase, resulting in reduced diversity of lenders. As lenders focus more on price paid to the government, they might pay less attention to service quality.

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[27] The budget-scoring effects for loans sold with a guarantee are beyond the scope of this report.

In the short term, auctions may have any of several effects on the number of FFELP lenders. They may increase lender participation by enabling new lenders to enter the market on relatively equal terms with existing lenders. It is also possible that auctions would increase large lenders' dominance of the secondary market. Large lenders would have several advantages over small lenders. Because they can usually obtain loan funds more cheaply and can spread their costs over a larger volume of loans, large lenders would generally be able to outbid their smaller competitors. In addition, auctions would necessarily make lenders uncertain about their prospects of continuing to participate in FFELP. Small lenders are more likely than large lenders to be deterred by this uncertainty.

Over the long term, lenders who do not win in one auction might leave FFELP permanently, if they find it expensive to reenter the market. If losing bidders drop out permanently after each auction, then the number of bidders could gradually decline, leading to higher federal costs. However, it is also possible that the losing bidders—especially those participating by holding and servicing loans from prior years—will not leave FFELP. With a loan sale, a participant who has been a winner for 3 years but does not win in year four will probably not leave FFELP, because that lender still has revenue from the previous years' loans. That lender may find it easy to reenter in the next year, and this may be less a concern than in the loan origination rights auction model.

One way the Congress could ensure lender diversity and pervasive participation would be to include special provisions, such as installment payment payments, that would protect small bidders' ability to compete. Although small-bidder protections may restrict the ability of larger firms to compete, they may also improve the overall competitiveness of the market. Another way of promoting competition in auctions is to adopt rules to ensure that all bidders are able to pay the amounts they bid. Without such rules, nonserious bidders could distort the auction results by placing bids that were unrelated to their valuations of the rights. Details of auction provisions regarding these features are presented in appendix III.

Loan sale auctions may affect the service quality of loan origination. In some models, such sales could remove competition from loan origination and could eliminate existing incentives to continuously improve the efficiency of the origination process. A single originating lender may not feel competitive pressure and therefore might be less likely to introduce new and innovative loan options.

There is some concern that auctions could shift the nature of competition in the student loan market toward price competition and away from service quality competition. At present, FFELP lenders compete to some extent on the basis of price through discounts to preferred borrowers. They also compete to some extent on the basis of service quality. Auctions would force lenders to place more emphasis on price competition, since the major (and, in most variants, the sole) criterion for determining auction winners would be the price bid. It is possible, although not certain, that lenders would pay less attention to service quality as they paid more attention to price.[28]

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[28] Service quality could be higher if multiple servicers rather than only one servicer were allowed. If students have the opportunity to select servicers or to choose a lender for consolidating loans, servicing lenders would have

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Loan sales could simplify the origination process for borrowers and schools by centralizing the origination and distribution of all loans. Some transitional challenges could be anticipated and thus lessened through the use of a pilot program. Lenders choosing to continue their FFELP participation would face an adjustment period during which they would need to learn how to participate in auction sales. While the integrity of the student loan program is not expected to suffer, auctions would require the federal government to establish special rules to preserve competition.

Loan sales could extend FDLP's origination and distribution channels. Borrowers and schools would no longer be able to choose a lender. This change would require adjustments in the short run by schools not currently participating in FDLP. Since required transitions primarily affect loans entering repayment, the effect on student borrowers should be minimal. It is possible that the current distinction between FFELP and FDLP would be eliminated if all loans were sold at auction.

Lenders who continue in the program would have to learn how to participate in the new program. Regardless of the way auctions are designed, they require participating lenders to develop skills and procedures that they do not now have. Initially, lenders would need to make decisions without experience as a guide. In addition, the federal government could identify some potential logistical problems during the transition by conducting a pilot program before implementing a loan sales system. Using knowledge gained from the pilot program, it could then take steps to lessen those problems.

The government would have to adopt and enforce regulations to maintain competition in bidding and ensure that participating lenders were creditworthy. Rules to prevent bidders from colluding would be necessary, especially if the trend toward increased secondary market concentration continues. The nature and complexity of these rules would depend on the types of collusion to which a particular type of auction could be vulnerable.

Operating and administering a loan sales program require additional federal data collection. An installment payment option tied to borrower repayments would require tracking the payments received by participating lenders from borrowers and matching this information to lender installment payments. As previously discussed, obtaining and using accurate data are critical to effectively managing the program. Results of the analysis for the loan sale model are summarized at a broad level in table 11.

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incentive to compete for students on the basis of service quality. A proposed borrower Web interface would better inform borrowers of their repayment options, where and to whom to send their payments, and other related matters. This could serve to limit or reduce delinquency and reduce servicing issues.

Table 11: Summary of Analysis for Loan Sale Model

Description of model, including variations	The government or a government-designated entity originates loans. Private entities bid to purchase packages of loans, either after origination or upon borrower's graduation. Loans could be sold with or without a guarantee. Purchase could be paid up front or financed and paid over time.
Costs, savings, and effects on subsidies for program participants	Federal costs could be lower; effect would depend on how loans are packaged. No federal payment would be made to originating lenders. Federal payments to guaranty agencies could be reduced or delayed. Borrower costs would be unaffected.
Effects on lender participation, loan availability, and service quality	Loans would be available to all. The concentration of loanholders could increase. Schools could serve as loan originators. The service quality in repayment could decline.
Simplicity, regulatory burden, and program integrity	Simple for borrowers; federal role more complex. Continuing lenders must learn auction mechanism. Program integrity is not expected to suffer.

CHAPTER 5

FEDERAL FUNDING

The federal funding model would give lenders the opportunity to borrow from the federal government funds with which to make FFELP loans. Borrowing could be provided as an option to lenders or could be made mandatory for lender participation in FFELP. Lenders would be required to bid on the interest rate they would pay to the government for the use of the federal funds. The total amount of federal funds available to FFELP lenders would be limited. Lender yield would be set legislatively and could be the same as the maximum borrower interest rate, which is currently based on Treasury rates. This model would affect lenders' cost of funds rather than lender yield. Federal costs could increase, decrease, or remain the same. Some roles of FFELP participants could change, depending on how the model is implemented, including major changes for the role of lenders. The model could also potentially affect the ability of schools and students to work with lenders of their choice, as well as the availability of loans and the quality of service to borrowers.

DESCRIPTION OF MODEL, INCLUDING VARIATIONS

In the federal funding model, the federal government would auction to lenders a predetermined volume of federal funds set aside for them to use to make FFELP loans. Each bid would include an interest rate and the volume the bidder wanted to borrow at that interest rate. The interest rate at which each winning lender borrowed, in conjunction with a legislatively set lender yield that could equal the FFELP maximum borrower interest rate, would determine that lender's net yield. Borrowing from the federal government could be made mandatory for lenders who want to participate in FFELP, or it could be offered as an option, with lenders still being allowed to fund student loans by traditional methods. Finally, lenders could repay the funds they borrowed from the government on either a regular amortization schedule or a schedule tied to borrower repayments on the FFELP loans made with the federal funds.

Basic Model and Roles of Participants

The federal government would estimate the volume of loans that students will demand in a given year. Lenders would submit one or more bids for a portion of the total volume. For example, a lender could bid for a certain volume at one interest rate, and then additional volume at a different rate, for as many different rates as desired. The agency operating the bidding system would collect all bids, sort the interest rates from high to low, and total the volume that all bidders desired at each interest rate. The interest rate emerging from the auction would be the lowest interest rate bid at which the sum of the desired volumes just exhausted the volume of federal funds being allocated. All lenders whose bids were above or equal to this rate would receive the allocation they bid. To prevent any one lender from gaining an unacceptably large share of the FFELP market, the government might limit the volume of federal funds that any lender could receive.

As in the current FFELP, the Congress would continue to set the maximum borrower interest rate. The reference rate for the maximum borrower interest rate (and the lender yield) could be any interest rate. However, because lenders would be likely to borrow from the government at Treasury-based rates (that is, at rates that are markups over the interest rate paid on a Treasury debt instrument), the Congress might consider keeping the maximum borrower rate Treasury-based as well and changing the lender yield back to a Treasury-based rate. This rate could change from the 91-day rate to a longer-term rate. By giving lenders a Treasury-based source of funds, this model could allow the borrower rate to remain Treasury-based and give lenders the ability to match-fund.[29]

The bidding is likely to be based on the same Treasury rate as the basis for the maximum borrower interest rate, to eliminate concerns about basis risk.[30] For example, the relevant Treasury rate could be the 91-day T-bill rate or the 10-year Treasury bond rate. The interest rate for bidding could then be expressed as a specified number of percentage points above or below the Treasury rate.[31]

The lender yield for FFELP loans would continue to be set legislatively. One option is for the Congress to set the lender yield equal to the maximum FFELP borrower interest rate so that the government makes no SAP.[32] Lenders' net yield, which depends on the difference between the legislatively set yield and their funding and operations costs, would be affected in this model by changes to funding costs.

To ensure that loans were available to students, lenders who won at auction would be required to use the entire volume they borrowed from the government to originate FFELP loans. Lenders would be required to return the unused portion of funds borrowed. To avoid having the government lend more funds than necessary, requiring a process to accommodate the return of funds, lenders could apply for federal funds after originating the FFELP loans. Otherwise, the government would need to match the timing of lender borrowing and payment to the corresponding student loan disbursements and repayments. In other respects, this model would leave the roles of FFELP participants unchanged. In addition, FDLP could remain as it is today, with terms for students the same as in FFELP.

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[29] "Match funding" refers to lenders matching the basis of the interest rate at which they borrow to finance a loan with the basis of the interest rate that they receive from the loan. If they are able to do so, then changes in the interest rate affect their costs and revenues identically and do not affect their net profits. If their funding costs and their revenues are based on different interest rates and those rates do not move in tandem, then their net profits could fluctuate.

[30] Basis risk is the risk created by a mismatch between the interest rate at which an entity borrows and the rate at which it lends. For example, borrowing at a CP-based rate and making loans at a Treasury-based rate introduces risk because, if the CP rate were to rise relative to the Treasury rate, borrowing costs would rise relative to income from the loans. This would reduce profits.

[31] Another option would be to establish a borrowing rate and then conduct bidding in terms of the price that lenders are willing to pay to borrow at that rate rather than bidding on the rate directly. For example, the rate could be set at the maximum borrower rate plus a small markup, and lenders could bid a dollar amount for the right to borrow a certain volume of federal funds at that rate. Lenders willing to pay the most would win the right, and enough winners would be selected to exhaust the volume that was put up for auction.

[32] The government would presumably still pay lenders a SAP if the borrower rate were high enough to hit its cap.

Major Variations on the Model

Participation in this system could be made optional or mandatory for FFELP lenders. Lenders could be offered the option of borrowing from the federal government or funding their FFELP loans and competing as they do now. The lender yield would have to be sufficiently high that nonparticipation was a realistic option and nonparticipants could make a reasonable profit. If the lender yield were too low, participation would effectively become mandatory. Alternatively, participation could be made mandatory so that only lenders who took part in this borrowing would be allowed to make FFELP loans.

The volume of federal funds that the government would have to make available at auction would depend on whether federal funding were mandatory or optional for lenders. If lenders were required to use federal funds for FFELP loans, or if federal funding were mandatory in effect even though optional in principle, then the government would have to set aside sufficient funds to meet the loan volume that it expected students to need. If lenders' use of federal funding were truly voluntary, then the government would have to set aside less than the total loan volume expected.

Auction design details, such as the choice of bidding method, could affect the results. These design issues are common to all the auction models we discuss in this report. For further details on auction design issues, see appendix III.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Federal FFELP costs under this proposal could increase, decrease, or remain the same. Costs could decline as a result of a bidding process if auctions were sufficiently competitive. The frequency with which auctions were held and the choice of bidding methods could also affect federal FFELP costs. (See app. III for an explanation of these issues.) However, the federal government would also face new risks and potential costs in a federal funding model. The most significant would be that lenders who obtain federal funding might be unable to repay the money they borrowed from the government, although the likelihood of this might be quite low. Requiring lenders to meet certain criteria for borrowing federal funds could mitigate this risk. The cost of distributing funds to and collecting repayments from lenders would be an additional source of increased federal government costs for FFELP. Some of a cost increase might be recovered by reducing or eliminating the SAP.[33]

In addition, the federal government could face conflicting incentives in the guarantee process. If the federal government is both reinsuring student loans and providing funds for them, then strict enforcement of due diligence rules could create a loss risk for the government. For example, if an FFELP loan loses its guarantee because of improper servicing, the lender might have difficulty repaying a portion of the funds it borrowed from the government. If the guarantee were maintained, the lender would receive the insurance payment for the defaulted loan and would then have funds available to repay the government. In effect, the government could be seen as guaranteeing its own loans. However, the federal guarantee could operate in different ways. Rather than paying a default claim, the government could simply reduce the amount that the lender owes by the amount of the default. Or, if a student defaults, the guaranty agency might pay the government directly (with that portion of the lender's debt to the government being erased) rather than the guaranty agency's paying the lender.

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[33] If due diligence regulations are not followed or something else threatens the guarantee, one recourse that Education has now is to withhold SAP payments to the lender. If the SAP were eliminated, the government might have less leverage over the lender than it now has.

This model would change net yield for lenders by determining their funding costs rather than affecting lender yield. Net yield depends on lender yield and costs, such as funding and operating costs. Most of the market mechanism models use the mechanism to explicitly set the lender yield, but this model uses it to set one portion of costs. Either approach ultimately has an effect on net yield.

Costs could decline for lenders who used federal funds. If these federal funds bear a low enough interest rate, then lenders' costs could decrease and their net yield could increase. Additionally, if the model gives lenders a source of funds tied to Treasury rates, potentially allowing lenders to match their revenues from FFELP loans, lenders would not bear the risk and costs of interest rate mismatches. Lender costs could be lowered as lenders gained the ability to match the movement in their cost of funds to the movement in the lender yield. As noted, both would be likely to be based on Treasury rates, so lenders would face no basis risk.

If lenders were not required to use federal funds to originate FFELP loans, then participating lenders might be forced effectively to give up all or some of the savings they realized in order to make competitive bids. This could, in turn, affect discounts offered to borrowers. Participating lenders' costs might remain unchanged or decline. Therefore, those lenders' gross profit margins might remain unchanged or increase.

If lenders were required to use federal funds to originate FFELP loans, then lenders might be forced to give up all or some of the savings they realized, or even more than the amount of those savings, to make competitive bids. This could also affect discounts to borrowers. Lenders' costs could increase, remain unchanged, or decrease. Lenders' gross profit margins could, therefore, decline, remain unchanged, or rise.

An implicit subsidy to borrowing lenders would be present if lenders had the use of federal funds before student loan disbursements and after loan repayments by student borrowers.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND SERVICE QUALITY

This model could potentially reduce the diversity of lenders, particularly if lenders were required to use federal funding to originate FFELP loans. Additionally, the relationships among FFELP participants could substantially change. The effects of federal funding on loan availability would depend on whether lenders' use of federal funding were optional or mandatory and on whether and sufficient federal funding were available. The service quality could decline if federal funding were mandatory for FFELP.

If lenders using this process secured significant funding cost advantages relative to other lenders, and if other aspects of FFELP remained competitive, then over time competition could squeeze out nonparticipating lenders or force them to participate. Lenders with different costs of funds, such as those who have access to tax-exempt funding compared with those who do not have access to it, would be affected differently. The process might effectively become mandatory to ensure profitability, at least for certain types of lenders, and the number and diversity of lenders could decrease.

Like origination rights auctions, federal funding auctions can reduce the participation of small lenders in FFELP, especially if the use of federal funding is mandatory. Small lenders, who usually cannot borrow funds in the private market at rates as low as those paid by large lenders, might not be able to bid as high for federal funds as large lenders could. If maintaining a large number of lenders or a diversity of lender types is desired, certain design features could be built into the model. Appendix III describes these options.

Several questions remain about lenders' relationships to the federal government. The process might be seen as reducing the lenders' role to that of a contractor for a system that appeared similar to FDLP. In contrast, lenders would own the loans they originate, and they would still compete on price and service quality after getting their funding. A further consideration is whether, after a change from private to federal funding for FFELP, private sector funding could be brought back easily if it were deemed necessary.

The effects of federal funding on loan availability would depend on whether lenders' use of federal funding were optional or mandatory and on whether sufficient federal funding were available. If federal funding were mandatory and the volume of federal funds auctioned were insufficient to meet student needs, then loan availability would be reduced. If federal funding were mandatory but the federal government auctioned a sufficient volume of funds to meet student needs, then some students might have temporary difficulty finding a lender who had federal funds available from which to lend, but permanent effects on loan availability would be unlikely. If federal funding were optional, then loan availability might be less likely to be affected because FFELP lenders would have access to alternative sources of funds.

Under this model, service quality might decline or remain unchanged. If a particular lender did not win any federal funding in a particular year (or even over a longer time period), then the borrowers and schools that were accustomed to dealing with that lender would have to go to other lenders during that year. Borrowers might have more difficulty meeting their repayment obligations if they had to deal with multiple lenders than if they could each deal with a single lender. Some borrowers might be more inclined to consolidate their loans rather than deal with multiple lenders. In addition, schools could lose the ability to work with nonwinning lenders and could be required to adapt their information technology systems and student financial aid procedures to accommodate winning bidders. These concerns, including fixed investments in computer technologies specific to particular lenders, could be important for high-quality service to schools.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Bidding on the interest rate lenders would pay the federal government would require its own set of administrative decisions and a regulatory framework for how the bidding process would be conducted. If criteria for lender participation in the auction were established, beyond criteria that lenders must currently meet to participate in FFELP, these would add to administrative burden. As with origination rights auctions, lenders could face difficulties during the transition to federal funding, and both the transition and the timing of auctions could affect the availability of loans to student borrowers. Some transitional challenges could be anticipated and thus lessened through the use of a pilot program.

Operating and administering a federal funding program would create additional data collection needs. The government would need to keep track of the funds borrowed by participating lenders and match lender draw-downs to the timing of student loan disbursements and match lender loan payments to loan repayments by student borrowers. As mentioned previously, collecting sufficient and accurate data is key to managing the program and reducing the risk of loss of government funds. Executive agencies have expressed concern about the federal funding model. In addition, the federal government could identify some potential logistical problems during the transition by conducting a pilot program before implementing a federal funding system for all FFELP loans. Using knowledge gained from the pilot program, it could then take steps to lessen those problems. The results of the analysis for the federal funding model are summarized at a broad level in table 12.

Table 12: Summary of Analysis for Federal Funding Model

Description of model, including variations	Lenders would borrow funds from the federal government to make FFELP loans. The process could be made optional or mandatory for FFELP participation. Lenders would be charged an interest rate determined through a bidding process.
Costs, savings, and effects on subsidies for program participants	Federal FFELP costs could increase, decrease, or remain the same. Funds borrowed from the federal government might not be repaid. Lenders could potentially eliminate risks from interest rate mismatches.
Effects on lender participation, loan availability, and service quality	If federal funding were optional, lenders could continue to participate in FFELP and not change behavior. If participating lenders secured significant cost funding advantages, all lenders might have to use federal funding, and lender diversity might eventually decline. Loan availability should not be threatened if sufficient federal funds are made available. Service quality could decline or remain unchanged.
Simplicity, regulatory burden, and program integrity	Regulations would be required to govern the bidding process. Additional requirements might be possible to allow lenders to participate in auctions.

CHAPTER 6

MARKET-SET RATES

A FFELP guaranteed student loan program with market-set borrower and lender interest rates would use competition to determine the interest rates and other terms and conditions of student loans. The primary distinguishing feature of this model is that the borrower rate, as well as the lender yield, would be determined in the marketplace and rates could vary across borrowers and lenders. Student borrowers, or schools, would shop for the most favorable loans. Lenders would charge the interest rates that borrowers agree to pay. Other possible changes might include no legislatively mandated rate ceiling for borrowers, no federal subsidies to lenders, and no federal payment of interest while borrowers were in school. Because of this, federal costs would be likely to decline in a simple version of the model. Lenders could offer interest rates and other loan features based on the needs of different students at different schools. Competition might lead lenders to offer different loan packages to different students on the basis of lenders' perceptions of risks and costs. Because a federal guarantee on student loans would remain, the range of rates might not be exceptionally wide. In addition, the increased competition might induce improvements in loan origination and processing that could improve the delivery system for both schools and students. Some study group members believe all students should receive a comparable interest rate set by the Congress. Allowing the market to set the rate is likely to affect students with the greatest need. Market-set rates could reduce or eliminate some borrowers' access to loans. However, there are variations to this model that could ameliorate this problem. The market-set rate model would also place a greater burden of adjustment on all FFELP participants than would the other models we discuss in this report.

DESCRIPTION OF MODEL, INCLUDING VARIATIONS

In the model we describe in this chapter, student borrowers, or schools negotiating on their behalf, would shop among lenders for the best available interest rates. Market competition would determine the interest rates lenders would receive, which would be the same as the interest rates borrowers would pay. Particular versions of the model differ according to how, if at all, they limit variation in interest rates among borrowers.

Basic Model and Roles of Participants

Market competition would determine interest rates for both borrowers and lenders. Lenders would charge the interest rates that borrowers agree to pay. The current federal loan guarantee would remain, but the federal government would provide no other subsidies to borrowers or lenders. Lenders could offer different interest rates to different students at different schools on the basis of their evaluations of how default risks and servicing costs differ among students and schools. Students or their representatives would be able to shop among lenders for the best available interest rates, possibly using interest rate information that would become available over the Internet. However, because students are often too inexperienced to shop for loans, schools would be likely to shop on their behalf. In the market, schools would be likely to be able to negotiate better interest rates for students and to choose a limited set of lenders with whom to conduct business.

Whether the student or the school does the shopping for the loan and loan terms could change the loan terms actually provided to the student. It is logically possible that the school will have concerns that do not line up exactly with the interests of the student. For example, ease of administration and support for the school's lending operations may be more important to the school than to the student. In contrast, the student may be more interested in the interest rate and the ease of dealing with the lender after graduation.

The current mix of federal and state roles in operating the mechanisms could change. In the simplest version of this approach, the federal government would no longer set the rate ceiling or other terms and conditions of FFELP loans. However, because the federal guarantee would remain, due diligence rules for servicing would still be required, and they would affect loan terms and conditions. The role of the states need not change. State guaranty agencies and secondary markets could continue to function.

The market-set rates model would require student borrowers, or schools acting on their behalf, to be well-informed about the characteristics of loans available in the market. Without accurate and timely information, students or schools would be unable to evaluate loans offered to them or negotiate effectively with lenders. Schools or students would need information about loan terms offered to all types of students, for all types of schools, and in all regions of the country. With such data available, students and schools could compare their loan offers and rates with offers and rates made in other circumstances. These comparisons would not eliminate all rate and service differentials. However, such information would facilitate students or schools in finding the best option.

Major Variations on the Model

The extent to which interest rates vary among borrowers could be limited in several ways, or it might not be limited at all. One option would be to allow market competition to determine interest rates without any restriction on the rates that lenders could charge. If the Congress believed that this option was unacceptable because it would make loans unaffordable for some borrowers, resulting in unacceptably high average borrower interest rates, or produce too much variation in borrower interest rates, then it could choose one of three methods of limiting variation in borrower rates. It could

designate a lender of last resort,

limit the extent to which a lender could offer different rates to borrowers presenting similar risks and costs, or

provide an interest rate subsidy to all FFELP borrowers, which need not be constant.

The federal government could serve as a lender of last resort, using either FDLP, a newly established lending program, or designated private lenders. The private lender or lenders would have to be paid because the lenders would presumably not otherwise lend at the designated rate.

The Congress would need to determine the interest rate that the lender of last resort would be allowed to charge, decide on the compensation to be paid to the lender of last resort, and set criteria for borrowers to be eligible to borrow from the lender of last resort.

Another option would be to limit variation in the interest rate or origination fees that a lender could offer to a group of borrowers. The federal government could define groups of borrowers by student or school characteristics that are associated with varying levels of servicing cost or default risk. For example, borrower groups could be based on average loan balances, type of degree sought, or type of school attended. The federal government would limit the interest rate or origination fee differences that would be allowed within each group but would not restrict these differences between groups. FHA imposes this type of limitation on the variation in "mortgage charge rates," analogous to FFELP origination fees, among recipients of the home mortgages it guarantees. Market competition determines the interest rates and fees on FHA-guaranteed mortgages, and different borrowers pay different rates and fees. However, FHA divides mortgages into groups on the basis of location and characteristics affecting prices and charges, such as fees or costs. FHA limits the difference between the highest and lowest mortgage charge rate within a group in any time period to 2 percentage points.

A final option would limit the rate level by setting a federal subsidy for borrowers for all FFELP loans. Such a subsidy would lower the interest rate for all borrowers by the same number of percentage points. It would also preserve borrowers' incentive to shop for the lowest interest rates, since a borrower would always benefit if he or she could find a lower rate. Furthermore, this subsidy could be uniform for all borrowers or could vary by the same student or school characteristics—average loan balances, type of degree sought, or type of school attended—as designated above. For example, borrowers in short-term programs or schools with high default rates, who might face the highest rates in the marketplace, could receive larger subsidies than those in other programs or schools, to try to ensure a more uniform rate for all borrowers.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Market-set rates are likely to reduce federal costs in the simplest version of the model, in which government payments to lenders would be eliminated. Subsidies to borrowers would be reduced in most versions of the model. Average borrower interest rates would probably rise in the short run but could increase, decrease, or remain unchanged in the long run. However, interest rates are likely to vary more among borrowers than they do today, increasing for some borrowers and possibly declining for others; thus, federal cost savings might come at the expense of borrowers who pay higher rates, potentially making some schools unaffordable for some borrowers. Lower initial interest rates for the lowest-cost, lowest-risk borrowers might replace the discounts that some lenders currently offer to those borrowers. A shift to market-set borrower interest rates in FFELP would also be likely to necessitate a change in the method by which FDLP interest rates were determined.

In the simple version of the model, federal FFELP costs under a system of market-set rates are likely to be lower than they are now. Federal costs include the cost of the federal loan guarantee, payment of interest while borrowers are in school (for subsidized Stafford loans), and payments to lenders to cover the difference between the lender interest rate and the maximum borrower rate. By eliminating the federal government's payments of in-school interest and its payments to lenders, the market-set rate model would lower federal FFELP costs. (The cost of the loan guarantee would not change, assuming that the guarantee structure did not change and that these program changes did not affect default rates.) If the federal government had to serve as lender of last resort or pay private lenders to do so, or subsidize borrowers, then it would incur extra costs, which would reduce or eliminate the federal savings from switching to market-set rates. If the federal subsidies or lender-of-last-resort costs were great enough, federal costs for FFELP could increase.

Market-set rates would eliminate all federal payments to lenders in the simplest version of the model. Under most options, there would be no federal subsidies to borrowers. Subsidies to borrowers would continue to exist only if the federal government chose to limit differences in borrower interest rates, or reduce the rates for all borrowers, by paying a subsidy to all borrowers. Eliminating the rate cap or making it less binding for all borrowers would be a major change in federal policy, which historically has set the same rate cap for all borrowers.

In the short run, the interest rates that borrowers pay, on average, would be likely to be higher than they now pay. In the long run, the average borrower rate could be higher than, lower than, or the same as at present. In the simplest version of the model, in the short run, eliminating the federal cap on borrower interest rates and federal subsidies to lenders would probably cause the average borrower rate to rise. In variants of the model that included methods of limiting borrower interest rates, borrower rates could increase by a lesser amount, or remain unchanged, in the short run. However, the long-run effect on borrower rates in any version of the model would depend on whether lender participation in FFELP increased or decreased. If lenders' freedom to set interest rates induced entry by new lenders and increased participation by current lenders, then those rates might fall. If some current lenders exited the FFELP and no new ones entered, then borrower rates could increase.

Market-set rates would probably increase the variation in the interest rates different borrowers pay, raising some borrowers' rates while lowering others'. The increase in variation may not be large, however, since the federal government would still guarantee 98 percent of the principal of each loan. Currently, the legislatively set borrower interest rate cap limits the amount of variation in borrower rates. The market-set rate model would allow some borrowers' rates to exceed the current ceiling. Borrowers that lenders perceived as having high servicing costs or high default risks (for example, those who had low loan balances or who attended schools with high student loan default rates) could face higher rates. These borrowers could end up paying interest rates exceeding the current ceiling. In the long run, interest rates for borrowers with low servicing costs or low default risks could decrease, if market competition eventually caused their average borrower rate to fall. In that event, low-cost, low-risk borrowers, who now receive discounts that give them interest rates below the ceiling, could pay even less.

Low-cost, low-risk borrowers might pay lower up-front interest rates instead of receiving discounts. Currently, lenders often give those borrowers interest-rate discounts after repayment begins. With increased competition at the front end of the loan, lenders might offer those borrowers lower contractual interest rates, leaving less flexibility for rate discounts during repayment. However, lenders might still offer discounts for good performance or for automatic electronic payment if offering those discounts increased profits for lenders.

In addition to affecting FFELP borrower interest rates, a system of market-set rates would probably require a change in the method of setting borrower interest rates in FDLP. Currently, FDLP rates are based on FFELP borrower rates. If FFELP borrower rates were determined through market competition, then they would probably vary more across borrowers and over shorter periods of time than they do now. It would become more difficult to base FDLP rates on FFELP borrower rates because of the increased variation in the latter. It would be possible to set FDLP rates on the basis of an average of FFELP borrower rates over a designated period of time.[34] Alternatively, the Congress could set an FDLP interest rate independently of FFELP borrower rates. This option, however, would be likely to make determining FDLP interest rates at least partially a political decision and potentially set a ceiling for FFELP loans.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND SERVICE QUALITY

Market-set rates could give lenders a continuing incentive to reduce their costs. If student loan markets are somewhat competitive, lower-cost lenders can offer lower rates and increase their market shares and profits. In addition, lenders setting higher rates will lose customers unless they are providing superior levels of service and other loan features attractive to borrowers. They might reduce the quality of service or leave it unchanged but might have less incentive to improve it than in the current system. Effects on lender diversity are uncertain. Some borrowers would be likely to lose access to FFELP. This problem would be somewhat mitigated if there were a lender of last resort. During a transition period, some borrowers who would ultimately have access to FFELP loans could be temporarily unable to obtain them, while other borrowers who would ultimately lose access might be able to borrow under FFELP.

Lenders' costs would also be likely to continue to decline after a market-set rate system was put in place. If lenders had to compete for business from students or schools that wanted to obtain low interest rates, then they would face a continuing incentive to cut interest rates. To cut interest rates and maintain a sufficient profit to make it worthwhile for them to remain in FFELP, lenders would have to reduce their financing, origination, or servicing costs. Because any lender who could gain a cost advantage over competitors would gain borrowers at their expense, all lenders would be under continuing pressure to keep costs low.

Market-set rates might reduce service quality or have no effect on it. The balance of competition in the student loan market might shift toward price competition and away from service quality competition. At present, FFELP lenders compete to a limited extent on the basis of price, through discounts to preferred borrowers. They also compete on the basis of service quality. Under market-set rates, lenders might place more emphasis on price competition. It is possible, although not certain, that lenders would decrease their emphasis on service quality as they paid more attention to price.

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[34] The method chosen for setting the direct loan rate would also affect budget scoring for both programs.

It is also possible, although not certain, that market-set rates would reduce service quality by weakening long-term relationships between lenders and schools. At present, schools maintain lists of "preferred lenders." Financial aid officers become knowledgeable about the practices of those lenders. Some schools' computer systems are programmed to deal with lenders on their preferred lists. Since schools often serve as intermediaries between lenders and students, school-lender relationships can improve service quality if they help schools assist students in dealing with lenders. In a system of market-set rates, schools might choose lenders on the basis of price and sacrifice these long-term relationships with lenders. If students chose lenders directly, they might not choose the lenders with which their schools previously had ongoing relationships. However, it is also possible that students and schools would see value in lender-school relationships and be unwilling to sacrifice these relationships to obtain slightly lower interest rates.

The effect of market-set rates on lender diversity is uncertain. If lenders' freedom to set interest rates attracted new lenders into FFELP in the long run, then lender diversity could increase. Alternatively, with increased price competition, large lenders who could invest in the human capital and servicing systems that would enable them to offer low interest rates might drive other lenders out of FFELP and prevent new lenders from entering. Similarly, secondary market lenders could be affected, if competition drove less efficient lenders and secondary markets out of the market via mergers. However, consolidations of lenders and secondary markets are already occurring in FFELP. It is possible that those consolidations would continue under a system of market-set rates and that market-set rates would have no effect on them.

Without a lender of last resort or a substantial federal interest rate subsidy, some borrowers could be priced out of the FFELP market. In a system of market-set rates, lenders would face incentives to charge high interest rates to borrowers they saw as having high risks of default or high servicing costs. For example, they would be likely to charge high rates to students in low-income regions, those from low-income families, and those attending proprietary vocational schools. Lenders would be likely to consider those kinds of students as presenting especially high default risks. Similarly, they might offer higher rates to borrowers in short-term programs or schools at which they are unlikely to end up with high loan balances, such as community colleges. Since loan servicing costs are relatively fixed, borrowers with low loan balances are more expensive to service on a per-dollar basis. If the interest rates that lenders were willing to offer some students were so high that those students were unwilling to pay them, then those students would not be able to obtain FFELP loans. Although the federal loan guarantee would reduce the extent to which different students posed different risks to lenders, it might not be sufficient to prevent some students from losing access to FFELP. A lender of last resort or a substantial federal subsidy could eliminate this access problem.[35]

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[35] Regulations restricting variation in interest rates lenders could charge might not eliminate the problem because lenders might find it unprofitable to lend to the highest-risk or highest-cost students at any rate that the regulations would permit.

During a transition to market-set rates, access to FFELP loans could be reduced from its current level but might differ from what it would be after lenders, schools, and students adjusted to the new rate-setting system. Because lenders would charge the highest-risk and highest-cost students rates that those students might not be willing to pay, those students could lose access to loans. However, differences in interest rates and student access during a transition period need not be the same as those that would ultimately exist in a system of market-set rates. Students, or schools acting on behalf of students, might need time to develop expertise at shopping for low interest rates. During a transition period, their lack of expertise might keep rates higher than they would ultimately be, and some students could initially be priced out of FFELP. Lenders would also need time to develop expertise in assessing the risks and costs of lending to different kinds of students. The criteria they initially used to determine interest rate offers might not be the same as those they would later use. Therefore, some students could be priced out of FFELP during a transition period but regain access to the program later. Likewise, some students who were able to obtain loans during the transition might later be priced out of the program. A lender of last resort or substantial federal subsidy could eliminate access problems that arose during the transition.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Eliminating most existing program regulations dealing with interest rates charged borrowers would likely simplify FFELP for lenders but would place additional burdens on borrowers and schools, and new regulations could make the program more complex for all participants.[36] The extent to which regulations become more complex or simpler will depend on program design features dealing with the exact extent of interest rate variability permitted and the extent to which borrower protection on servicing remain in place. In the simplest version of this model, the federal government would no longer set maximum borrower interest rates, pay interest while borrowers were in school, or pay subsidies to lenders. Eliminating these features of FFELP would probably make the program simpler for lenders. However, borrowers and schools may find the program more complex. In addition, the loss of access to loans, if it occurred, could burden some students. Any new regulations to preserve participation of small lenders could burden large lenders. New regulations designed to preserve both student access to loans and student or school incentives to shop could burden various program participants. The nature of those burdens depends on the type of regulation. For example, if the program limited the range of rates that a lender was allowed to charge different students, then lenders would face an additional burden. If students had to satisfy a complex set of criteria to be eligible to borrow from a lender of last resort, then borrowers who had difficulty obtaining loans from other lenders would face an additional burden.

Students, schools, and lenders would all have to adjust to changes in regulations and market practices. The adjustments that would be required are probably greater than those that the other models in this report require. If schools changed their preferred lender lists whenever lenders changed their interest rates, then students could have to deal with multiple lenders, and financial aid officers would have to deal with different lenders each year. This might require financial aid officers to face the confusion and administrative burden of constant changes in procedures and forms that different lenders required. The same results could occur if students rather than schools choose lenders. The confusion and difficulties of dealing with multiple lenders each potentially offering different interest rates and terms (unlike the present rates and terms that do not vary by lender) might increase the attractiveness of FDLP to schools. Lenders would have to determine their cost structures and provide mixes of prices and services that keep them attractive to students or schools. Students or schools would have to learn how to choose lenders. Students might also face difficulties dealing with multiple lenders. Guaranty agencies would have to deal with more lenders per student than they do now. Finally, the procedures for consolidating loans might need to change in order to accommodate the variety of interest rates and terms of FFELP loans. The results of the analysis for the market-set rates model are summarized at a broad level in table 13.

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[36] Even if regulations dealing with borrower rates were eliminated or modified, regulations dealing with servicing loans could remain unchanged.

Table 13: Summary of Analysis for Market-Set Rates Model

Description of model, including variations	Lender and borrower interest rates would be set by market competition. Borrowers would pay the rates lenders charged, unless the model included explicit subsidy for borrowers. Loans retain a federal guarantee. Options exist to limit variation in borrower interest rates Rate cap for students might be eliminated or less binding, representing a major federal policy change.
Costs, savings, and effects on subsidies for program participants	Federal costs could decline but could rise or remain unchanged under some options. Costs will likely rise for some borrowers and fall for others. Average borrower costs would be likely to rise in the short run; long-run effect is uncertain. Government payments to lenders and borrowers would be eliminated or reduced under some options.
Effects on lender participation, loan availability, and service quality	Lenders have continuing incentive to reduce costs. Service quality may decline or remain unchanged. Effect on lender diversity is uncertain. Loans would probably not be available to all students and schools and their ability to negotiate could be limited unless ameliorative policies were adopted.
Simplicity, regulatory burden, and program integrity	All FFELP participants would bear a substantial burden of adjusting to a new system. Borrowers or schools would have a greater burden to shop for loans. Eliminating some existing regulation would simplify FFELP for lenders, but new regulations could burden all FFELP participants.

CHAPTER 7

INCOME-CONTINGENT REPAYMENT

The Student Loan Reform Act of 1993 expanded the range of loan repayment options available under the federal student loan programs. Of interest in considering market mechanisms in these programs is the availability and use of the ICR plan in FDLP. Any of the proposed models for introducing market mechanisms into FFELP could include an ICR option or requirement. Under ICR, the amount of a borrower's monthly loan repayment varies with income over time. Some borrowers with low postgraduation incomes or high debt levels would make lower monthly payments with ICR than with other loan repayment options. With the monthly installment payment based on the borrower's income, it is also far more difficult in theory for the borrower to default. The availability of ICR expands options for student borrowers to choose educational programs or careers that are less likely to provide a high income. Student borrowers who earn less make lower monthly repayments and are therefore also relieved of some of the risk associated with an uncertain future.

ICR DESIGN ISSUES COMMON TO MODELS

ICR design issues common to all market mechanism models include how borrowers' repayment terms should be determined, whether the federal government or private lenders should hold ICR loans, who should be able to choose or require ICR, and how borrowers' incomes should be verified.

Repayment Terms Under FDLP ICR Now and Alternatives

Any ICR plan must specify how a borrower's loan repayments are to be determined. Under the ICR option that now exists in FDLP, loan repayments depend in a complex way on income and other factors. Some borrowers may have portions of their principal or interest forgiven. Examples from other countries that use ICR illustrate alternative methods of determining repayment obligations in an ICR system.

In FDLP, borrowers may choose an ICR option under which monthly payments depend on income and, for some borrowers, loan principal and interest rate and marital status. Under this option, the borrower's monthly payment is the smaller of two amounts: (1) the amount the borrower would repay annually over 12 years in the absence of ICR, multiplied by an income percentage factor based on the borrower's and spouse's adjusted gross income (AGI) and marital status, or (2) 20 percent of the borrower's income in excess of the poverty level. The ICR repayment obligation is recalculated each year to reflect changes in the interest rate, income percentage factor, and poverty level. Appendix IV explains the repayment formula in more detail.

Under FDLP's ICR plan, the federal government subsidizes some borrowers by forgiving part of their principal or interest payments. Two kinds of subsidies are available to ICR borrowers in addition to those available to Stafford borrowers in general. First, if the borrower's monthly payment is less than the monthly interest accrued on the borrower's loans, then the unpaid interest is capitalized up to a limit of 10 percent of the original principal balance on each individual loan. The federal government writes off any unpaid interest that exceeds this limit. Second, the federal government forgives any unpaid loan balance remaining after 25 years in repayment. This forgiveness includes any remaining unpaid principal, unpaid interest, or charges on the borrower's loans.

Other countries that use ICR in their student loan systems illustrate alternatives to the FDLP method of determining ICR repayment obligations. For example, some countries have income thresholds below which loan borrowers are not required to make any repayments. Once the borrower has reached or exceeded the set threshold, payments are determined according a percentage of income, as in Australia, or of income above the threshold, as in New Zealand. In Sweden, payments are simply a percentage of total income, with no threshold. Loan forgiveness provisions vary widely. For example, Sweden forgives all student loan debt that the borrower has not repaid by age 65. New Zealand partially forgives interest payments for certain low-income borrowers. Countries with ICR systems also vary as to whether ICR is voluntary or mandatory. In some countries, such as Sweden, all borrowers use ICR. In New Zealand, ICR is the default option but borrowers may choose to repay their loans at a faster rate than required under ICR. In Australia, students indicate whether they wish to use ICR or pay their entire obligation up front. Numerous and significant differences between loan programs run by other nations make the relevance of these program features debatable.

ICR Loans Held by the Federal Government or Private Lenders

Either the federal government or private lenders could hold ICR loans in FFELP. One option that could be incorporated into all market mechanism proposals is to have the federal government, rather than the FFELP lender, hold the loans of borrowers who have chosen the ICR plan. For example, the government could buy at face value ("par") all privately held loans that were being converted from a conventional repayment plan to ICR. If the federal government initially held all FFELP loans (as under the loan sale proposal), then it could retain ICR loans and sell only non-ICR loans. In either case, the federal government could use a loan servicing contractor to service loans in the ICR plan. Borrowers could select ICR before or after entering repayment.

Private lenders could hold FFELP ICR loans under any of the market mechanism proposals. If lenders originated all loans, then they could continue to hold them or sell them to other lenders, regardless of whether a borrower chose ICR. If the federal government initially held all FFELP loans, then it could sell both ICR and non-ICR loans to private lenders. Privately held ICR loans raise special issues related to the verification of borrower incomes. Financing subsidies to borrowers could also differ between privately held ICR loans and publicly held ones. These issues are discussed later in this chapter. An additional option would be for private lenders to hold ICR loans but have them serviced by the government of its contractor.

Borrowers could elect to leave ICR, regardless of whether the federal government or private lenders hold the loans. As with the current ICR program, the option of changing repayment plans could be incorporated into ICR under any of the market mechanism proposals.

Choosing or Being Required to Use ICR

In the current FDLP, a standard (non-ICR) repayment schedule is the default option but any borrower may choose to use ICR instead. Under a market mechanism approach, ICR in FFELP could continue with this freedom of borrower choice. Another possibility would be to allow only delinquent and defaulted borrowers to choose ICR as a last resort. If ICR were limited to delinquent and defaulted borrowers, another option would be to allow the lender to put a loan into ICR status. Alternatively, the federal government could mandate ICR for delinquent or defaulted borrowers, for borrowers whose student loan debts were large in comparison with their incomes, or even for all FFELP borrowers. A final possibility would be to make ICR the default option for all FFELP borrowers but to allow borrowers to choose a standard repayment schedule instead of ICR.

Income Verification

Regardless of whether the federal government or private lenders held ICR loans, the extent to which the Internal Revenue Service (IRS) should be involved in the verification process is a major policy decision that the Congress would face if ICR were included in FFELP. Income information on borrowers' federal income tax returns filed with IRS may be more accurate than income information that borrowers supply (such as pay stubs, bank statements, and borrowers' own copies of their tax returns). If borrowers supplied income information to the holders of ICR loans, then some borrowers might underreport their incomes, especially if the ICR plan includes a future discharge of indebtedness. Even if loan holders required ICR borrowers to present certified copies of their tax returns, fraud could still be an issue. Education's Office of Inspector General found that student aid applicants, even when required to provide a copy of their tax returns as part of the Free Application for Federal Student Aid (FAFSA) verification process, cannot always be relied on to provide accurate information.[37] For these reasons, IRS involvement in the verification process may be desirable. However, IRS has, in general, argued that the use of tax return information for "non-tax collection" purposes undermines public confidence in the tax system and, therefore, reduces voluntary taxpayer compliance with tax laws.

More specific policy decisions about IRS involvement in income verification depend on whether the federal government or private lenders would hold ICR loans under FFELP. If the federal government held the loans, then one possible method of verifying income would be the one currently FDLP's ICR plan uses. In FDLP ICR, two methods of income verification are used: IRS data-matching and borrower-supplied "alternative documentation" of income. Alternative documentation consists of a pay stub, dividend statement, or canceled check or, if none of these is available, a signed statement that explains the borrower's income sources and provides its address. Alternative documentation of income is required for the first year a borrower is in repayment and, for certain borrowers, for the second year. Otherwise, IRS data-matching is used to verify income. Appendix IV explains the FDLP income-verification procedure in more detail.

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[37] Education, Office of the Inspector General, *Accuracy of Student Aid Awards Can Be Improved by Obtaining Income Data from the Internal Revenue Service*, ACN: 11-50001 (Washington, D.C.: Jan. 29, 1997).

If the federal government held FFELP ICR loans and if IRS information were used in verifying borrowers' incomes, then a second policy issue might be whether or how federal contractors involved in administering ICR should be able to obtain information from federal income tax returns. Contractors now handle loan operations, such as origination and servicing. Education requires FDLP ICR borrowers to sign a consent form giving contractors permission to obtain information about their incomes from IRS.[38] Either the Congress (through legislation) or Education and Treasury (through regulation) may wish to consider whether a similar method of borrower consent should be used for ICR in FFELP.

For the current FDLP ICR plan, Education and IRS have devised a system in which consent forms are transmitted to IRS electronically for review. (See app. IV for details.) Education then transmits to IRS the items of information to be verified for those taxpayers. Treasury estimates that 100,000 consents are processed each year. Education and Treasury have been working toward a possible statutory or regulatory solution to this paper-intensive approach. The separate consent form is arguably a significant paperwork obstacle to borrowers completing the ICR application process. In addition, the form itself may heighten borrower concern about the federal use of tax return data.

If private lenders held ICR loans, then the main income-verification issue would be whether lenders should be able to obtain borrower income information from IRS or should be required to rely on income information that borrowers supply. As discussed above, borrower-supplied information may be less accurate than IRS information. Some members of the lending community have suggested that lenders could collect income information from FFELP ICR borrowers and share it annually with Education. Education would then compare the self-reported data with actual IRS tax return data through some type of data exchange to ensure that the self-reported income was accurate within a predefined tolerance. Treasury has stated that in order for this to occur, either taxpayer consent or an amendment to the IRC would be necessary.

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[38] The Internal Revenue Code authorizes Treasury to disclose information about FDLP ICR borrowers' identities, tax filing statutes, and AGI to officers and employees of Education for the purpose of determining the appropriate ICR amount (26 U.S.C. 6103(l)(13)). Because Education uses contractors to administer FDLP, these disclosures are made on taxpayer consent forms filed with IRS. Subject to certain limitations, the Internal Revenue Code allows Treasury to disclose a taxpayer's federal income tax return information to any person if the taxpayer requests this disclosure (26 U.S.C. 6103(c)).

ICR VARIATIONS IN THE DIFFERENT MARKET MECHANISM MODELS

ICR could be incorporated into any of the market mechanism proposals discussed in this report. Some features of ICR would vary, depending on the market mechanism proposal chosen. In particular, the federal acquisition of ICR loans could differ for some market mechanisms, federal payments to private lenders that held ICR loans would exist in only one market mechanism, and any subsidies to ICR borrowers would probably have to be financed differently for different market mechanisms.

Federal Acquisition of ICR Loans

In all the market mechanism models except loan sales, if the Congress decided that the federal government should hold FFELP ICR loans, then the federal government would have to buy from private lenders all loans for which borrowers chose or were required to use ICR. In the loan sale model, in which the federal government would originate all loans and then sell loans to private lenders, it would not auction loans that were designated ICR loans. Under loan sales, if a borrower chose or were required to use ICR after a private lender had bought his or her loan, then the federal government would have to repurchase that loan from the lender.

Federal and Borrower Payments to Private Lenders Holding ICR Loans

Under all the market mechanism models, if private lenders held ICR loans, then lenders would receive the income-contingent payments that borrowers made. In addition, under adjustments to the current system only, they would continue to receive a SAP, based on the difference between the lender yield and the maximum borrower interest rate.

Financing Subsidies to ICR Borrowers

If private lenders held ICR loans, then the federal government might or might not reimburse lenders for the costs of ICR borrower subsidies (that is, for uncapitalized interest and for loan balances forgiven after 25 years). Under all market mechanism models, the federal government would pay the costs of the subsidies if it reimbursed lenders for the costs of these subsidies. However, a decision by the Congress not to require the federal government to reimburse lenders for the costs of the subsidies could mean, depending on the market mechanism model, that lenders, borrowers, or the federal government actually paid the costs of the subsidies.
Under adjustments to the current system, if the federal government reimbursed lenders for the costs of borrower subsidies, then federal FFELP costs would be higher than if lenders received no reimbursement. If the federal government did not reimburse lenders for the costs of borrower subsidies, then FFELP lenders would pay for the subsidies. However, lender participation in FFELP would probably be reduced, and loan availability might also be reduced.

Under the federal funding model, if lenders borrowed at a predetermined interest rate, then lenders' costs would be higher if the federal government did not reimburse them for borrower subsidy costs. Such a cost increase would be likely to reduce lender participation in FFELP, reduce any discounts currently available to borrowers, and possibly reduce loan availability.

Under all auction models, including the auction variant of federal funding, whether the federal government reimbursed lenders for the costs of borrower subsidies would not affect whether the federal government actually paid those costs. Lenders' bids would depend on whether the federal government reimbursed them for those costs. If it did not reimburse lenders, then lenders' bids would reflect the increase in expected costs attributable to ICR. If loans (in the loan sale model) or origination rights (in the origination rights auction or volume procurement model) were grouped, bids would be lower for groups in which borrowers were more likely to receive ICR subsidies. Alternatively, ICR loans or the right to issue ICR loans could be auctioned separately from other origination rights. Under all auction models, the government would bear the anticipated cost of ICR subsidies in the form of lower revenue from bidding lenders. The net result could be higher or lower federal costs associated with privately held ICR loans, depending on whether the private lenders operating expenses were higher or lower than those of federally operated ICR.

Under market-set rates, if the federal government did not reimburse lenders for the costs of borrower subsidies, then lenders would probably charge borrowers higher interest rates, which would reflect the expected costs attributable to ICR. Therefore, borrowers would be likely to bear the anticipated cost of ICR subsidies for privately held loans. The borrowers whom lenders believed most likely to use ICR would bear the greatest share of the costs of the ICR subsidies. Regulatory limits on the rates lenders could charge may reduce the availability of FFELP loans, especially to borrowers whom lenders thought most likely to use ICR.

APPENDIX I

MANDATE FROM THE HIGHER EDUCATION AMENDMENTS OF 1998

This appendix reprints section 801 of the Higher Education Amendments of 1998 (HEA), Pub. L. No. 105-244.

> (a) Study Required.—The Comptroller General and the Secretary of Education shall convene a study group including the Secretary of the Treasury, the Director of the Office of Management and Budget, the Director of the Congressional Budget Office, representatives of entities making loans under part B of title IV of the Higher Education Act of 1965, representatives of other entities in the financial services community, representatives of other participants in the student loan programs, and such other individuals as the Comptroller General and the Secretary may designate. The Comptroller General and Secretary, in consultation with the study group, shall design and conduct a study to identify and evaluate means of establishing a market mechanism for the delivery of loans made pursuant to such title IV.
>
> (b) Design of Study.—The study required under this section shall identify not fewer than 3 different market mechanisms for use in determining lender return on student loans while continuing to meet the other objectives of the programs under parts B and D of such title IV, including the provision of loans to all eligible students. Consideration may be given to the use of auctions and to the feasibility of incorporating income-contingent repayment options into the student loan system and requiring borrowers to repay through income tax withholding.
>
> (c) Evaluation of Market Mechanisms.—The mechanisms identified under subsection (b) shall be evaluated in terms of the following areas:
>
> (1) The cost or savings of loans to or for borrowers, including parent borrowers.
>
> (2) The cost or savings of the mechanism to the Federal Government.
>
> (3) The cost, effect, and distribution of Federal subsidies to or for participants in the program.
>
> (4) The ability of the mechanism to accommodate the potential distribution of subsidies to students through an income-contingent repayment option.
>
> (5) The effect on the simplicity of the program, including the effect of the plan

on the regulatory burden on students, schools, lenders, and other program participants.

(6) The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower.

(7) The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders.

(8) The effect on program integrity.

(9) The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans.

(10) The availability of loans to students by region, income level, and by categories of institutions.

(11) The proposed Federal and State role in the operation of the mechanism.

(12) A description of how the mechanism will be administered and operated.

(13) Transition procedures, including the effect on loan availability during a transition period.

(14) Any other areas the study group may include.

(d) Preliminary Findings and Publication of Study.—Not later than November 15, 2000, the study group shall make the group's preliminary findings, including any additional or dissenting views, available to the public with a 60-day request for public comment. The study group shall review these comments and the Comptroller General and the Secretary shall transmit a final report, including any additional or dissenting views, to the Committee on Education and the Workforce of the House of Representatives, the Committee on Labor and Human Resources of the Senate, and the Committees on the Budget of the House of Representatives and the Senate not later than May 15, 2001.

APPENDIX II

LIST OF STUDY GROUP MEMBERS

APPOINTED BY EDUCATION AND GAO

Corye Barbour
Legislative Director
United States Student Association

Bill Beckmann
President and Chief Executive Officer
Student Loan Corporation

Mary F. Bushman
Vice President, Government Relations
AFSA Data Corporation

Kathy Cannon
Senior Vice President
Bank of America

Judy Case
Director of Financial Aid
University of Massachusetts Medical School

Rene R. Champagne
Chairman, President and Chief Executive Officer
ITT Educational Services, Inc.

Jacqueline Daughtry-Miller
Vice President, Student Loan Department
Independence Federal Savings Bank

Anthony P. Dolanski
Director, Sallie Mae Servicing
Sallie Mae, Inc.

Ivan Frishberg
Higher Education Project Director
U.S. Public Interest Research Group

Richard D. George
President and Chief Executive Officer
Great Lakes Higher Education Corporation

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Director of Student Financial Aid
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Deborah Mott
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Ferris, Baker Watts, Incorporated

Barmak Nassirian
American Association of Collegiate Registrars and Admissions Officers

Chalmers Gail Norris
Executive Director
Utah Higher Education Assistance Authority

Richard H. Pierce
President and Chief Executive Officer
Maine Education Services

Susan L. Pugh
Director, Office of Student Financial Assistance
Indiana University

Marilyn B. Quinn
Executive Director
Delaware Higher Education Commission

Robert A. Scott
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Patricia Smith
American Association of State Colleges and Universities

Paul S. Tone
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Laurie Wolf
Director, Enrollment Management
Des Moines Area Community College

Paul W. Wozniak
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DESIGNATED BY FEDERAL AGENCIES

Nabeel Alsalam
Principal Analyst
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Barbara Bovbjerg
Director, Education, Workforce, and Income Security Issues
U.S. General Accounting Office

Robert Cumby
Former Deputy Assistant Secretary, Office of Economic Policy
U.S. Department of the Treasury

Maureen McLaughlin
Deputy Assistant Secretary, Office of Postsecondary Education
U.S. Department of Education

Lorenzo Rasetti
Program Examiner
Office of Management and Budget

APPENDIX III

TECHNICAL ASPECTS OF AUCTION DESIGN

Several of the policy options we reviewed in this report, particularly those in chapters 3 and 4, involve some sort of auction mechanism for setting the terms on which student loans are originated. The purpose of this appendix is to review the relevant theoretical and empirical literature on auctions.

IDEAL CONDITIONS FOR AUCTIONS TO WORK

Standard theoretical treatments of auctions in the economic literature generally assume that the objective of the party conducting the auction is pecuniary—that is, that a successful auction is one that provides the most favorable price quotations by bidders.[39] Bidders are likely to make more attractive bids, other things being equal, when the following conditions are present: a large number of bidders, easy entry and exit conditions for bidders, as much relevant information as possible available to bidders, and the existence of secondary markets. However, in many practical situations, the state of the market deviates from the ideal conditions described above. For example, as we noted in chapter 1, the student loan market has been characterized by the concentration of much of the business in the hands of a few large lenders.

The competitiveness of a market can affect the success of auctions, but auctions themselves can influence the competitiveness of the market. In the short term, auctions either may make the market more competitive or may have no effect on competition. They may increase competition by enabling new participants to enter the market on relatively equal terms with existing participants. Alternatively, auctions may have no effect on competition if entry into the market is so expensive that no new participants are willing to enter. In the long term, it is possible that auctions will gradually reduce competition and, in the case of FFELP, increase federal costs, although how likely this outcome is cannot be known.

The current student loan market, however, may not be competitive enough to enable auctions to produce savings for the federal government. This may be because a few large lenders dominate the student loan market and it is costly for new lenders to enter the market. The dominant lenders' influence on the winning bids could conceivably lead to FFELP costs that are as high as or higher than current costs. Lenders might also collude in setting their bids. The relatively small number of lenders in the market would make collusion easier.

The student loan program is distinguished by several nonpecuniary policy objectives, such as encouraging participation by small lenders, maximizing access by student borrowers, and maximizing families' choices of postsecondary education options.

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[39] As we noted in chapter 3, in the context of the student loan program, this could be defined in one of several ways: the interest rate offered by bidders, a markup over a reference rate such as a T-bill rate or the CP rate, or a price to be offered by bidders. Unless otherwise noted, the discussion in this appendix pertains to any pecuniary outcome.

OPTIONS FOR AUCTION DESIGN

There are various ways of structuring the auction process. We review several of the variants that have been used in financial markets or that have been proposed for the student loan program. Where appropriate, we note aspects of auction design that might be significant when the auction is being conducted under less than ideal conditions. Although most of the available theory and evidence pertains to the implications of auction designs for pecuniary outcomes, we also note the implications of auction design for nonpecuniary policy objectives. This list is by no means exhaustive. Although we indicate whether a particular auction design may be more or less conducive to attaining certain objectives than another auction design, we do not generally answer the question of whether auctions as such are superior to nonauction methods of setting interest rates and other terms for student loans.

Uniform Versus Multiple Prices

In an auction for multiple identical items, where bidders can bid on different quantities of the item, competitive bids state the amount and price desired and are ranked from the highest to the lowest price. Bids are accepted at successively lower prices until the desired level of funds has been raised or all items have been sold. In a uniform-price auction, all winning bidders then pay the same price—the cut-off price.[40] By contrast, in a multiple-price auction, all accepted bids are filled at the price that each bidder bid, so some wining bidders pay more than others.

Treasury recently made a transition from multiple-price auctions to single-price auctions in its auctions of Treasury securities. A Treasury official told us that the uniform-price auction was expected to produce benefits, from Treasury's point of view, in that it would encourage more bidders to participate in bidding by reducing the importance of specialized knowledge regarding market demand and the information costs associated with its collection. It expected that the concentration of bidders would decline and that there would be more revenue to the Treasury. Its analysis of data from the initial experience with single-price auctions lends modest support for these predictions.

Single Versus Multiple-Round Auctions

Rather than selling items one at a time, a large set of related items can be auctioned simultaneously, with the auctioning continuing for multiple rounds until the best possible price is attained for all items. FCC uses multiple-round auctions for some of its auctions of licenses. The auction closes when all bidding activity has stopped on all licenses. The principal advantage of a multiple-round auction is the information that it provides bidders about the value other bidders place on a license. This information increases the likelihood that licenses will be assigned to the bidders that value them the most and will generally yield more revenue than auctions where there is much uncertainty about common factors that affect the value of a license to all bidders—that is, who bid and how much was bid. In a multiple-round auction, bidders need not guess about the value the second highest bidder places on the license because bidders have the opportunity to raise their bids if they are willing to pay more than the current high bidder.

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[40] A variant of this technique involves accepting the second highest bid.

Multiple-round bidding is also more likely than single-round bidding to be perceived by participants and observers as open and fair. Auction theory shows that multiple-round bidding tends to increase revenue by reducing the incentive for bidders to be overly cautious during bidding while trying to avoid the winner's curse—meaning the highest bidder would bid too much and regret its purchase. Multiple-round bidding provides information about other bidders' estimates of common information, thus reducing bidders' incentive to bid cautiously to avoid falling victim to the winner's curse and regretting their purchases.

An auction that has a single round of bidding is faster than one with multiple rounds, and the bid evaluation process is simpler. Also, a multiple-round auction may be more vulnerable to collusion than a single-round auction and an auction in which each bidder pays a different price could be either more or less susceptible to collusion than one in which all bidders paid the same price.

Sealed Bid Versus Open Outcry Auctions

In a sealed-bid auction, each bidder submits a single bid. The bids are then all opened at once and the winner is determined. By contrast, in an open-outcry auction, bidders submit bids publicly and then have the opportunity to revise their bids in light of other bids. Open-outcry auctions are generally not used in financial markets. A Treasury official told us that for Treasury auction, it was important to minimize event risk—that is, the risk that market conditions will change while the auction is ongoing. An open-outcry auction for Treasury securities might increase this risk.

Auction Frequency

In a potential auction in FFELP, whether for loan origination rights or for loans that have already been originated, how frequently auctions would be held would be an important decision. FFELP costs could be higher the more frequently auctions were held. Because there would be some costs to conducting each auction, the total administrative costs of auctions would be higher the more frequently auctions were held. Similarly, the cost to lenders of bidding in auctions would be higher the more frequently auctions were held, which could reduce the number of bidders. More frequent auctions could also result in fewer bidders because some lenders would not find it worthwhile to enter the FFELP market if they could not be sure of remaining in it for a long time. With less competition among lenders, federal payments to lenders could be higher.

However, there are also reasons why FFELP costs could be lower with more frequent auctions. Because lower-cost lenders can outbid those with higher costs, lenders would have a greater incentive to reduce their costs the more frequently auctions were held. Therefore, federal payments to lenders could be lower with more frequent auctions. In addition, lenders might increase their profits during the time between auctions if they were able to reduce their costs during that time. The federal government would capture more of these profit increases and could therefore make lower payments to lenders the more frequently auctions were held. Furthermore, more frequent auctions reduce lenders' risk that the interest payments they would receive would be out of line with their cost of funds. Therefore, more frequent auctions could make origination rights more valuable to lenders, reducing federal payments to them. Finally, more frequent auctions could make it more difficult for a few lenders to become entrenched as perennial auction winners. Thus, auction winners could face more competition at each auction. This competition could lead to lower federal payments to lenders.

Lender participation could be either higher or lower the more frequently auctions were held. Because the cost to lenders of bidding in auctions would be higher the more frequently auctions were held, more frequent auctions could mean fewer bidders. Small lenders might be especially sensitive to the costs of bidding. However, because more frequent auctions reduce lenders' risk that the interest payments they would receive would be out of line with their cost of funds, they could make origination rights more valuable to lenders, inducing more lenders to participate. Also, more frequent auctions could make it more difficult for a few lenders to become entrenched as perennial auction winners. Thus, past auction winners could face more competition at each subsequent auction.

Frequent auctions could impose substantial burdens on lenders, students, and schools. Because participating in auctions would cost lenders both money and time, more frequent auctions would be more burdensome to lenders. Because both students and schools value the ability to deal with a single lender, more frequent auctions could impose a greater burden on them by disrupting long-term student-lender and school-lender relationships. Less frequent auctions could have a negative effect on service quality. Lenders whose rights to originate loans were secure for many years might pay less attention to service. Students might then become confused about their repayment responsibilities and the default rate might rise. However, less frequent auctions could also improve service. Students value the ability to borrow from a single lender. Having this ability could make it easier for them to keep track of and repay their debts, thereby reducing the default rate. The more frequently auctions were held, the more likely it would be that a student would have to change lenders, especially if each auction had only one winning lender per school. This effect of auction frequency on service quality could be eliminated in several ways, though. Each student could be allowed to remain with one lender throughout his or her educational program, even if a different lender subsequently won origination rights at his or her school, or students who had more than one lender could retain the right to consolidate all their loans. Less frequent auctions could also improve service quality by facilitating long-term relationships between lenders and schools. The more frequently auctions were held, the more likely it would be that a school would have to change lenders, especially if each auction had only one winning lender per school.

Grouping

It is possible that auctioning origination rights or loan volume for small groups of schools would produce higher federal FFELP costs than auctioning rights or volume for larger groups or conducting auctions without grouping schools. However, there is no information available to enable us to determine how likely this outcome would be. If the per-student cost of originating loans declines as the number of students served increases, then it is less expensive for each lender to serve a large number of students than to serve only a few students. Under these conditions, total lender costs are lower when there are a few lenders, each of which serves many students, than when there are many lenders, each of which serves a few students. Therefore, federal payments to lenders would be greater when each of a large number of auction winners served a small number of students than when each of a small number of winners served many students. If schools were bundled into small groups when auctions were held, then it is possible that the auctions would produce a large number of winning lenders, each of which would serve relatively few students. This outcome could be less likely if schools were bundled into large groups or if schools were not grouped at all. Thus, federal payments to lenders could be higher the larger the number of school groups. For example, federal payments to lenders could be greater if schools were grouped by state than if origination rights for all FFELP-eligible schools were auctioned as a single package.

Likewise, it is possible that FFELP costs would be higher if multiple lenders were permitted to serve each school than if there were only a single lender for each school. Once again, there is no information available to enable us to determine the likelihood of this outcome. As the previous paragraph showed, it is possible that federal payments to lenders would be greater if each of a large number of auction winners served a small number of students than if each of a small number of winners served many students. If many lenders were allowed to serve students at each school, then there could be a large number of winning lenders, each of which served relatively few students. This outcome could be less likely if only one lender were allowed per school. Federal payments to lenders could be greater with multiple lenders per school than with a single lender per school.

How schools were grouped together in the auctions would be likely to affect the distribution of federal payments to lenders. If schools were not grouped or if the characteristics of each group of schools resembled those of FFELP-eligible schools as a whole, then the distribution of those payments would probably be similar to what it is at present. However, if schools in each group were similar to one another but different from those in other groups, then lenders would bid more for the right to originate loans in the groups they perceived as more desirable (for example, those with higher per-student loan amounts and lower default rates) than for the right to originate in "less desirable" groups. Federal payments to lenders who won origination rights in the "less desirable" groups would then be greater than federal payments to lenders who won rights in the "more desirable" groups. The resulting pattern of unequal federal payments to lenders would give the federal government better information about the costs of lending to students at different schools, but in so doing it could also lead to an erosion of political support for FFELP. A similar pattern of unevenly distributed federal payments to lenders would likely result if lenders were allowed to define their own groups of schools when they bid. If lenders defined their own groups of schools, they would probably group schools according to such characteristics as per-student loan amounts and default rates.

Students in low-income regions, from low-income families, or attending proprietary vocational schools could lose access to loans if Education grouped similar schools together or allowed lenders to define their own groups of schools. In a volume procurement auction, those types of students could lose loan access if winning lenders were allowed to choose the students to whom they would lend. Lenders would be likely to consider those kinds of students as presenting especially high default risks. If they were allowed to, some lenders might refuse to lend to students with those characteristics or to bid on groups of schools that served such students. If similar schools were grouped together or if lenders were permitted to group schools themselves, then groups of schools that lenders perceived as serving students with high risks of default (for example, schools with very high student loan default rates) might attract no bids. In a volume procurement auction in which winning lenders were permitted to choose their borrowers, lenders might refuse to lend to students at those schools.

Ability to Pay

Auctions that involve payments to a government entity by a successful bidder for specified rights, as opposed to offering an interest rate, would require rules to ensure that bidders were able to pay the amounts they bid. Without such rules, nonserious bidders could distort competition. Other federal auctions provide examples of rules that could be adopted in an origination rights auction. EPA requires each bidder in its sulfur dioxide emission allowance auctions to send a certified check or letter of credit to cover its bid before the auction, or else to specify a method of electronic transfer or other payment method. (This rule is feasible only for sealed-bid auctions, in which each bidder submits a single bid.) FCC requires bidders in its wireless spectrum auctions to submit refundable deposits to cover the cost of placing bids. A final option, not used in any federal auction, is to require all potential bidders to show some evidence of their ability to pay. One way of implementing this option is to use FFELP eligibility criteria as evidence of ability to pay. Another alternative is to require FFELP-eligible lenders to pass additional ability-to-pay tests before allowing them to participate in the auction.

Federal costs could depend on whether winning bids are payable in full immediately after the close of the auction or whether a schedule of installment payments is allowed. Installment payments enable small bidders to participate more easily. Small bidders would have to come up only with a down payment rather than with the full purchase price, enabling bidders with less funding to compete with better funded large bidders. However, allowing loan purchasers to pay in installments could result in winning bidders not paying off the installments. When FCC allowed some spectrum auction winners to pay their bids in installments, it experienced many defaults by auction winners. This raised a related issue of who owns the auctioned item (student loans) if the purchaser declares bankruptcy. In the case of wireless spectrum rights FCC auctioned, bankruptcy of winning bidders has left the disposition of the auctioned item to be determined by a bankruptcy court. Solving this issue with respect to student loan packages before implementation will enable Education to reclaim and resell such loans in subsequent auctions.

Small Bidders

Some federal auctions use several methods of ensuring small bidders' access. In its auctions of federal debt, Treasury allows small buyers not to participate in the auction and to agree in advance to buy a limited, pre specified amount of debt at the price that emerges from the auction. (Of course, only a small minority of buyers could use this option. If many buyers decided to use it, then the auctions would have few bidders and would not work properly.) Treasury also imposes a 35 percent limit on the market share of any winning bidder. FCC offers bidding credits to small bidders. In addition, FCC formerly allowed auction winners to pay their bids in installments, but this policy resulted in many defaults by auction winners. Independent of its annual auction, EPA gives electric power plants some sulfur dioxide emission allowances for free.[41] In the early years of its auctions, EPA also sold allowances at a fixed price outside auction. However, the price it set turned out to be much higher than the market price, and it later abandoned this practice.

Evidence from the FCC wireless spectrum auctions suggests that small-bidder protections can make auctions more competitive. In some early auctions, FCC gave preferential treatment to certain categories of bidders (such as women-owned and minority-owned businesses) for certain types of licenses. This policy intensified bidding competition among the nonpreferred bidders. At the same time, preferred bidders bid more for the licenses that were subject to the preferences than nonpreferred bidders would have been willing to pay for the same licenses. The preferences increased auction revenues.

Commercial Paper Versus Treasury Rates

FFELP costs could be lower if the maximum borrower interest rate were based on the CP rate than if it were based on the 91-day T-bill rate. Under current law, the maximum borrower interest rate is based on the 91-day T-bill rate and the lender's cost of funds is based on the CP rate. The relationship between the 91-day T-bill rate and lenders' cost of funds is relatively unstable. For this reason, federal payments to lenders that are based on the CP rate are more valuable to lenders than federal payments that are based on the 91-day T-bill rate, for loans made at the same predetermined interest rate. A convenient way of setting a predetermined lender interest rate would be to set it equal to the borrower interest rate. Thus, if the borrower rate were based on the CP rate, lenders' bids would be more favorable to the government than if the borrower rate continued to be based on the 91-day T-bill rate. FFELP costs would be lower if the basis for the borrower rate were changed to the CP rate.

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[41] In addition to protecting small lenders, free distribution of some student loan origination rights before auction could be a method of phasing in origination rights auctions.

APPENDIX IV

DETAILS ON INCOME-CONTINGENT REPAYMENT IN FDLP

THE RATIONALE FOR ICR

ICR gives borrowers the opportunity to repay student loans based on their income. One analyst has stated that current economic conditions place a greater burden on borrowers than conditions of previous eras did. Low inflation means that today's graduates and borrowers will pay back, in real terms, as much as 40 percent more than student loan borrowers who graduated in the 1970s and 1980s. Graduates of earlier eras benefited from paying back their loans in cheaper dollars. Current borrowers cannot depend on inflation to reduce their "real" debt burden. However, today's graduates may have higher inflation-adjusted postgraduation incomes than graduates of the 1970s and 1980s. We are unable to determine whether today's graduates face higher debt burdens relative to their incomes than graduates of earlier eras. However, if today's graduates do face higher debt burdens than graduates of the 1970s and 1980s, and if it is believed that today's graduates should have the same debt burdens as graduates of those earlier decades, then a properly designed and administered ICR plan can be justified as one way to reduce the burden for today's graduates. ICR allows some borrowers with low incomes or high debt burdens to maintain a good credit rating by making lower monthly payments than they would have to make under a standard repayment schedule. With the monthly installment payment based upon the borrower's income, it is also far more difficult in theory for the borrower to default. The availability of ICR also expands the educational and occupational options for student borrowers. It may be especially valuable for some borrowers who are in the early stages of their careers.

DATA ON ICR

The Student Loan Reform Act of 1993 expanded the range of loan repayment options available under the federal student loan programs. Of interest to the study group on market mechanisms in the student loan programs is the use of the various repayment plans available in FDLP, especially the ICR plan. The use of the various repayment plans varies significantly by whether the loan was a consolidation loan. Thus, we are providing an analysis of overall ICR usage in the Direct Loan program as well as ICR usage among consolidation borrowers.

All Loans in Repayment

Nearly 2.7 million borrowers have loans in repayment under FDLP. They have loan amounts totaling nearly $34 billion.[42] Of the total loan amount, 31 percent is subsidized Stafford loans, 17 percent is unsubsidized Stafford loans, 11 percent is PLUS loans, and 41 percent is consolidation loans.

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[42] All information is as of May 31, 2000.

Of the total amount in repayment,

56 percent is being repaid through the standard repayment plan,
20 percent is being repaid through the graduated repayment plan;
12 percent is being repaid through the extended repayment plan, and
2 percent is being repaid through ICR.

Roughly half of the loans being repaid under the ICR option require payments that are less than the interest due on the loan. See tables 14 and 15.

Table 14: Direct Loan in Repayment by Loan Type

Loan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Subsidized	1,501,329	56%	$9,627,369,029	$10,431,517,693	$6,948	31%
Unsubsidized	932,386	35	5,861,802,639	5,694,855,988	6,108	17
PLUS	372,453	14	3,335,602,873	3,788,560,419	10,172	11
Consolidation	709,786	26	13,447,855,619	14,070,935,315	19,824	41
Total[a]	**2,684,031**	**100%**	**$32,272,630,160**	**$33,985,869,415**	**$12,662**	**100%**

[a] Unduplicated borrower count.

Table 15: Direct Loans in Repayment by Plan

Repayment plan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	1,944,060	72%	$17,315,051,937	$18,884,768,619	$9,714	56%
Graduated	402,876	15	6,757,482,096	6,729,516,982	16,704	20
Extended	149,703	6	3,981,172,966	4,116,109,476	27,495	12
Income contingent repayment	193,289	7	4,041,457,111	4,049,233,342	20,949	12
Payments greater than or equal to interest	101,725	4	2,033,145,308	2,057,503,793	20,226	6
Payments less than interest	91,564	3	2,008,311,803	1,991,729,549	21,752	6
Alternative plan	10,740	0	177,466,051	206,240,996	19,203	1
Total[a]	**2,684,031**	**100%**	**$32,272,630,160**	**$33,985,869,415**	**$12,662**	**100%**

[a] Unduplicated borrower count.

Consolidation Loans in Repayment

As shown in table 14, consolidations are more than 40 percent of the Direct Loan repayment portfolio by loan amount. Education tracks this closely, as it allows borrowers to consolidate defaulted loans for the purpose of obtaining an income contingent repayment arrangement. Defaulted loans that are not being rehabilitated through the Direct Loan income contingent repayment or another reasonable and affordable plan are normally pursued and collected by collection agencies contracted by Education's Debt Collection Service (DCS).

Nearly 710,000 borrowers have consolidation loans in repayment totaling more than $14 billion in original loan amounts. Almost all (95 percent) of the $14 billion in original loan amounts are "regular" consolidation loans. The remaining 5 percent represent loans previously held by DCS. See table 16.

Of the total consolidation amount in repayment (table 17)

29 percent is being repaid through the standard repayment plan,
27 percent is being repaid through the ICR plan.
22 percent is being repaid through the graduated repayment plan, and
20 percent is being repaid through the extended repayment plan.

Roughly half of the loans being repaid under ICR require payments totaling less than the interest owed on the loan. See tables 16 and 17.

Table 16: Source of Direct Consolidation Loans in Repayment

Consolidation type	Number of borrowers	Percent of total borrower count	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Regular consolidation loans	598,715	84%	$12,762,306,108	$13,362,649,377	$22,319	95%
Defaulted loans formerly held by DCS	112,135	16	684,081,869	706,738,859	6,303	5
Total[a]	**709,786**	**100%**	**$13,446,387,978**	**$14,069,388,236**	**$19,822**	**100%**

[a]Unduplicated borrower count.

Table 17: Direct Consolidation Loans in Repayment by Plan

Repayment plan	Number of borrowers	Percent of total borrower count	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	301,817	43%	$3,729,080,437	$4,145,517,660	$13,735	29%
Income contingent repayment	182,178	26	3,816,246,780	3,834,087,757	21,046	27
Payments less than interest	87,383	12	1,923,399,764	1,936,038,142	22,156	14
Payments greater than or equal to interest	94,795	13	1,892,847,016	1,898,049,615	20,023	13
Graduated	137,190	19	3,053,074,468	3,101,952,324	22,611	22
Extended	84,028	12	2,730,481,991	2,852,202,918	33,943	20
Alternative plan	5,337	1	117,197,409	135,216,042	25,336	1
Total[a]	**709,786**	**100%**	**$13,446,081,085**	**$14,068,976,702**	**$19,821**	**100%**

[a]Unduplicated borrower count.

Of the loans being repaid through income-contingent repayment (see the 193,289 borrowers in table 15). Ninety-four percent are consolidation loans (see the 182,178 borrowers in table 17).

Of the consolidation loan amounts previously held by DCS, 11 percent are in ICR. Of the regular consolidation loan amounts, not previously held by DCS, 28 percent are in ICR. See tables 18 and 19.

Table 18: Direct Consolidation Loans in Repayment by Plan: Defaulted Loans Formerly Held by DCS

Repayment plan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	63,550	57%	$318,715,398	$343,082,099	$5,399	49%
Graduated	29,748	27	216,876,576	216,141,878	7,266	31
Income contingent repayment	11,778	11	80,719,328	77,778,778	6,604	11
Extended	6,905	6	66,899,517	68,730,851	9,954	10
Alternative plan	10	0	40,742	45,933	4,593	0
Total[a]	**112,135**	**100%**	**$683,251,561**	**$705,779,539**	**$6,294**	**100%**

[a] Unduplicated borrower count.

Table 19: Direct Consolidation Loans in Repayment by Plan: Regular Consolidation of Non-DCS Loans

Repayment plan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	238,397	40%	$3,409,473,808	$3,801,485,419	$15,946	29%
Graduated	77,204	13	2,663,424,434	2,783,316,598	36,051	21
Income contingent repayment	107,603	18	2,835,914,828	2,885,506,253	26,816	22
Extended	170,798	29	3,735,395,565	3,756,175,778	21,992	28
Alternative plan	3,523	1	89,756,731	103,761,954	29,453	1
Total[a]	**598,715**	**100%**	**$12,733,965,367**	**$13,330,246,002**	**$2,265**	**100%**

[a] Unduplicated borrower count.

ICR Usage Under FDLP

Although the ICR option appears to be more expensive for many borrowers over the full repayment term than, for example, the standard repayment plan, no ICR borrower "overpays" interest because the current plan has been established without an internal cross-subsidy. Analyses of possible repayment options, as well as contemporary repayment calculators that are provided to aid borrowers' choices among various repayment plans, are typically described in total dollars rather than in terms of the net present value of those dollars. This can make ICR seem to be more expensive for borrowers than it really is. Some observers believe that this illusory high-interest cost of ICR has discouraged financial aid administrators from urging borrowers to consider choosing it. Also, these analyses and repayment calculators at best can only assume, and cannot predict, a borrower's future income. Such projections have typically specified the historical income growth for college graduates (on average, 5 percent annually). However, ICR is more valuable to borrowers with a flatter income trajectory. The fact that ICR usage has not approached initial projections does not mean that ICR should be discarded. While the currently operational ICR plan may in fact be relatively unattractive to many borrowers, financial aid administrators' poor familiarity with it has certainly affected its take-up rate.

MONTHLY PAYMENT CALCULATION FOR LOANS IN ICR

The monthly payment calculation under ICR is the lesser of

> the principal balance and AGI based calculation or
> 20 percent of the borrower's discretionary income. These two calculations are explained below.[43]

Principal Balance and AGI-Based Calculation

The monthly payment is the amount the borrower would repay annually over 12 years, using standard amortization multiplied by an income percentage factor based on the borrower's or couple's AGI and whether the borrower is single or married and head of the household:

$$\text{12-year standard amortization} = \text{(principal balance)(monthly interest rate)/[1} \quad \text{(monthly interest rate + 1)}^{-n}\text{]}.$$

The monthly interest rate is equal to the annual interest rate divided by 12, and n is the number of months remaining in the repayment term.

For this calculation, the principal balance is the original principal balance plus any capitalized interest when the borrower first entered repayment. This amount remains static except for the following situations:

1. *Reporting new disbursements, disbursement adjustments, and cancellations.* The principal balance is adjusted to reflect these changes.
2. *A new loan is received after the new loan has entered repayment.* In this situation, the principal balance is the principal balance of the new loan when the loan first entered repayment plus any capitalized interest when the borrower first enters repayment plus the outstanding principal balance on the existing loans (including capitalized interest) plus outstanding accrued interest, collection charges, late charges, and any other charges.
3. *Borrowers request joint repayment.* In this situation, the principal balance is recalculated on the basis of the borrower's combined outstanding principal balance when the borrower enters

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[43] See also "Examples of the Calculations of Monthly Repayment Amounts," published annually in the *Federal Register*, most recently at 65 *Fed. Reg.* 34,006 (25 May 2000).

joint repayment plus any capitalized interest when the borrower first enters repayment plus the outstanding principal balance on the existing loans (including capitalized interest) plus outstanding accrued interest, collection charges, late charges, and any other charges.

4. *For purpose of the annual recalculation of the payment amount when new income information is received, after periods in which a borrower makes payments that are less than interest accrued on the loan.* In this situation, the principal balance is the highest outstanding principal balance (including amounts capitalized) calculated for the borrower while paying under the ICR plan if this amount is higher than the original principal balance when the loan first entered repayment, plus any capitalized interest.

The monthly payment calculation is principal based and AGI based monthly payment = (12-year standard amortization * income percentage factor).

The income percentage factor is obtained from a table published annually by the Secretary in the *Federal Register*.[44] If the borrower's exact AGI is not found in the table, the income percentage factor is obtained by linear interpolation between the next higher and next lower AGIs. The linear interpolation method calculates the income percentage factor on the basis of intervals between the incomes and income percentage factors on the table.

20 Percent of the Borrower's Discretionary Income

The borrower's discretionary income is calculated on the basis of poverty guidelines provided by the U.S. Department of Health and Human Services (HHS): discretionary income = AGI poverty guideline. Thus, the monthly payment calculation is discretionary income monthly payment = (discretionary income * 0.20)/12.

Treatment of Married Borrowers Not in Joint Repayment

For a married borrower to be eligible for ICR, the borrower's income information and the borrower's spouse's income information are required, even if the spouse files a separate tax return. Thus, both spouses are required to sign the IRS consent form. In addition, both spouses are required to provide the same required income type, AGI, or alternative documentation of income. If both spouses have direct loans and are in joint repayment, the servicer refers to the borrower who has the most recent in-school period to determine income type.

If the borrower is separated from the borrower's spouse, the borrower is not required to provide the spouse's income. The borrower is required to send the servicer a self-certifying statement that indicates the change in marital status. If the borrower is separated and the borrower filed a joint income tax return, the borrower may submit alternative documentation of income for only the borrower.

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[44] 65 *Fed. Reg.*_ 34, 007 (25 May 2000).

Treatment of Married Borrowers in Joint Repayment

Married borrowers may choose to repay their loans jointly under ICR. The decision to repay jointly under ICR does not make each borrower liable for the other's direct loan debt. Joint repayment is used as a method to determine the borrowers' monthly repayment amounts. In order to be eligible, both borrowers are required to request joint repayment on the Repayment Plan Selection Form. The payment amount is based on the borrowers' combined outstanding direct loan debt and the borrowers' combined income when the servicer calculates the borrowers' joint repayment amount. The borrowers' individual payment amount is determined so that each payment amount is proportionate to each person's level of debt. When payments are applied in any joint repayment situation, they should be applied to interest on both borrowers' accounts before they are applied to principal on either account. This helps avoid negative amortization on either account. Obviously, if payments are not high enough to cover interest on both accounts, there will be negative amortization. In cases in which both spouses choose joint repayment and the loans are serviced at different servicers, one of the borrower's loans will be transferred.

If the servicer holds the loans of only one borrower and the borrower is selecting ICR for the first time and wants to repay jointly, the servicer should wait until the spouse's loans are transferred before calculating the joint repayment amount. Therefore, the borrower should be put on interest billing, even if the servicer has income information for borrower and spouse. The borrower should be left on interest billing until the spouse's loans are transferred.

Married borrowers may select joint repayment, even if they filed their taxes separately. The ICR plan does not assume that a borrower's AGI is proportionate to his or her debt. A joint payment amount is calculated on the basis of the combined AGI and combined debt amounts. The borrower receives a bill for the portion of the joint payment amount that is proportionate to the borrower's individual debt.

ALTERNATIVE DOCUMENTATION OF INCOME

The servicer is required to collect alternative documentation of income for the first year a borrower is in repayment and for certain borrowers for the second year.[45] All married borrowers must submit alternative documentation of income for their spouses, unless the borrower is separated from the borrower's spouse. If the borrower has been in repayment for more than a year, the servicer must determine whether the AGI data or alternative documentation of income should be used to calculate the ICR monthly repayment amounts.

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[45] Documentation supporting the borrower's income can be in the form of a pay stub, a dividend statement, or a canceled check. If these types are not available, the borrower can provide a signed statement that explains each income source and provides its address. If the borrower provides the servicer with other forms of supporting documentation, the servicer determines whether the documentation is acceptable at its own discretion, with guidance from Education's On-Site Monitor. Supporting documentation of alternative documentation of income cannot be older than 90 days.

The servicer collects alternative documentation of income from borrowers if the borrower's AGI from IRS would be likely to reflect any period of time in which the borrower was in school. If AGI data do not represent an in-school period, the servicer uses the AGI data from IRS to calculate the monthly payment amount. If the borrower receives an in-school deferment, the servicer does not consider the time of the in-school deferment as an in-school period. In situations in which the borrower has multiple loans with the servicer, if any of the loans require alternative documentation of income, the borrower is required to provide alternative documentation for all the loans.

If the borrower is not required to submit alternative documentation of income, the servicer calculates the borrower's monthly payment amount using the borrower's AGI data from IRS. However, the servicer collects alternative documentation of income in situations in which IRS cannot provide the servicer with valid income information or if the borrower's reported AGI does not reasonably reflect current income. The servicer accepts the borrower's alternative documentation for the following situations:

the borrower has lost or changed employment or is undergoing some other special circumstances,
the borrower did not file a sufficiently recent tax return,
IRS provided income information but not currently enough to determine the payment amount, or
IRS did not provide AGI data during the first AGI solicitation and the borrower did not request the servicer to re-solicit IRS.

In addition to these situations, the servicer can use alternative documentation of income from the borrower even when IRS is processing a request for AGI data or if AGI data are received from IRS. However, alternative documentation of income cannot be submitted or solicited solely to reduce the amount of time a borrower is assigned ICR interest-only monthly payments. The guideline is to be used only if the alternative documentation most accurately reflects the borrower's current ability to repay the loan. If the servicer has both current AGI and alternative documentation of income, the servicer uses the alternative documentation of income to calculate the monthly repayment amount, unless the borrower requests otherwise.

If a borrower and the borrower's spouse have chosen to repay their Direct Loans jointly, the servicer refers to the spouse who most recently left in-school status in order to determine whether AGI or alternative documentation of income should be solicited.

ANNUAL INCOME INFORMATION RENEWAL

Each year, the servicer renews the borrower's income information, either by soliciting AGI data from IRS with the taxpayer's consent or by receiving updated alternative income information from the borrower. The servicer begins the annual income renewal process at the end of August. The servicer does not request updated income information if the servicer has received income information from the borrower within the past 6 months. For example, if the borrower entered repayment under ICR in March 1999, the servicer would not have renewed the borrower's annual income until August 2000.

If the borrower's loans require renewal of income information, the servicer must determine whether the borrower is required to submit alternative documentation of income or whether AGI data from IRS can be used. Valid AGI data cannot reflect an in-school period. If AGI data reflect an in-school period, the servicer uses alternative documentation of income to recalculate the monthly payment.

Renewal for Borrowers Who Require AGI

At the end of August each year, the servicer attempts to solicit IRS for AGI data for the borrower and spouse. If the servicer cannot obtain the AGI data, the servicer asks the borrower to submit alternative documentation of income. Alternative documentation is acceptable to recalculate the payment amount if the AGI data are not obtained from IRS or if the AGI data do not accurately reflect the borrower's current income. Once the servicer receives updated income information, the servicer recalculates the borrower's monthly payment amount. After the recalculation, the servicer discloses the borrower's new monthly payment amount.

If the servicer does not receive updated income information from IRS, or the alternative documentation of income form and supporting documentation from the borrower by the end of the calendar year, the servicer removes the borrower from the ICR plan. The servicer reverts the borrower's loans to the standard repayment plan, or to the borrower's previous repayment plan if the borrower switched to ICR from another repayment plan.

Renewal for Borrowers Who Require Alternative Documentation of Income

For borrowers required to submit alternative documentation of income, the servicer asks at the end of August each year for the alternative documentation of income form and supporting documentation for income renewal purposes. The servicer uses the AGI data from IRS to verify the borrower's previous year's alternative documentation of income information.

If the servicer does not receive the form and supporting documentation from the borrower by the end of the calendar year, the servicer removes the borrower from the ICR plan. The servicer reverts the borrower's loans to the standard repayment plan or to the borrower's previous repayment plan if the borrower switched to the ICR plan from another repayment plan.

IRS Consent Form

Before the servicer is able to solicit AGI data from IRS, the borrower and the borrower's spouse must provide the servicer with a valid and signed IRS Consent to Disclosure of Tax Information form. A married borrower is not eligible for ICR without an IRS consent form with both spouses' signatures and IRS validation of the form. When the servicer receives the form, the servicer ensures that the borrower and spouse have correctly completed it. If the form is incomplete, the servicer either sends an imaged copy of it with a new consent form or retrieves the original consent form and sends it to the borrower and spouse to complete. The borrower and spouse must either complete a new consent form in its entirety and submit it to the servicer or complete the original consent form and submit it to the servicer.

Once the servicer receives a completed IRS consent form, the servicer images the borrower's IRS consent form and passes the image to IRS within 3 business days. If the form is invalid—for example, if IRS receives the image of the form more than 60 days after the date when the borrower signed the form—IRS rejects it. If IRS rejects the form, the servicer requests the borrower to submit an updated form.

When IRS initially validates the form, the form is valid for 5 tax years. The 5 tax years are defined on the IRS consent form. Any subsequent renewals of the forms are also valid for 5 tax years.

Solicitation for IRS Consent Form Renewals

IRS consent form renewals are solicited in December of the year following the last covered tax year indicated on the form. For example, at the end of December 2000, the servicer has to begin the renewal cycle for all IRS consent forms that expired after the 1999 tax year. If the servicer does not receive a new IRS consent form from the borrower, the servicer requests an IRS consent form at least two additional times before the end of June. If the borrower does not provide an updated form, the servicer does not solicit updated AGI data in August. The servicer removes the borrower from the ICR plan the December following the initial renewal attempt if the borrower does not provide the servicer with an updated IRS consent form and if updated income information is not received.

If the borrower voluntarily revokes the IRS consent form, the servicer immediately removes the borrower from the ICR plan. If the borrower does not choose a new repayment plan, the servicer notifies the borrower that the servicer placed the borrower on the standard repayment plan.

Treatment of Married Borrowers

A married borrower is required to have his or her spouse's consent authorizing IRS to disclose tax information for the purpose of determining the borrower's AGI. The servicer requires both spouses to sign the IRS consent forms in order for a married borrower to participate in the ICR plan. Both spouses must sign the IRS consent form, even if the couple filed a joint tax return. Both signatures are required for all married borrowers, unless they are separated.

Soliciting AGI Data From IRS

The servicer solicits IRS for AGI data once a month. The servicer solicits the AGI data from IRS for a particular borrower either when initial or renewal AGI data are required. Depending on the AGI data sent by IRS, the following three situations could occur:

IRS mismatch. IRS is unable to recognize the borrower's or spouse's Social Security number or name as provided by the servicer.

No AGI data. The borrower or spouse did not file a tax return the previous year covered by the IRS consent form, or IRS provided outdated (or invalid) AGI data, because sufficiently current data were not available.

The servicer receives sufficiently current AGI data. IRS provides the borrower's or spouse's current AGI data.

If IRS cannot provide the servicer with AGI data because of a mismatch, no AGI data are available, or IRS sent outdated AGI data, the servicer only resolicits IRS for AGI data on the borrower's request. (The borrower is permitted to request that the servicer resolicit IRS for AGI data at any time.) If IRS cannot provide income information, the servicer requests alternative documentation of income from the borrower. When the servicer receives valid AGI data from IRS, the servicer calculates the borrower's monthly payment amount on the basis of the AGI.

Eligible AGI Data and Alternative Documentation for Borrowers Entering ICR

AGI data used to calculate the repayment amount must be current data. Prior or next-prior calendar year AGI data (or both, for a married borrower and spouse) from IRS are acceptable if received before August 31 for borrowers entering ICR who are required to provide AGI data. For information received after August 31, the servicer accepts only prior-year AGI data from the IRS. For example, 1998 or 1999 AGI data are acceptable if the servicer received the information from IRS before August 31, 2000. If the servicer received the information after August 31, 2000, only 1999 AGI data were acceptable. If the borrower submits alternative documentation of income, the only requirement is that the supporting documentation not be older than 90 days. If married borrowers have income information from two different tax years, the servicer designates the most current tax year to the income data.

Substitution for AGI Data

The servicer can accept a signed tax return with accompanying required documentation (for example, W-2 forms or 1099 forms) from the borrower as proof of AGI data, if the servicer cannot obtain the data from IRS. A signed tax return from the borrower cannot be considered alternative documentation of income but may be used temporarily to calculate the borrower's monthly payment. If the servicer receives a signed tax return from a borrower, the servicer attempts to recollect AGI data from IRS, using the signed tax return as proof that valid AGI data exist for the borrower. If the servicer continues not to be able to obtain AGI data from IRS, the servicer collects alternative documentation of income from the borrower to recalculate the borrower's monthly payment amount.

APPENDIX V

CALL OPTIONS AS A MECHANISM FOR DETERMINING NET LENDER YIELDS

Competitive forces in the market could help establish lender yield on loans and remove any "excess" lender profits through the inclusion of a "call option" on all new FFELP loans. The call option would give the federal government the right to "buy" the FFELP loan within a specified time period at a predetermined price ("exercise price") set by legislative formula. The exercise price would be set when the loan originates and would include consideration for a lender's cost in making the loan.

Within the specified time period, the government would auction the call option (the right to buy the loan). FFELP lenders willing to pay the highest positive value to the government for the option would receive the right to purchase the loan at the predetermined exercise price. The government would receive the bid price on the option. If lenders were unwilling to bid a positive value for the option, the federal government could purchase the loan at the exercise price or the originator would keep the loan.

The call option model uses competitive secondary market forces to determine the value of a loan. In determining whether and how much to pay for the call option, buyers review the expected value of the loan (including special allowance payments, interest payments, and so on) relative to the exercise price. When the expected value exceeds the exercise price, potential buyers would be likely to bid positive amounts for the option.

Assume solely for illustration that origination costs were 1 percent of the loan amount. The exercise price would be 101 percent of the face value of the loan and would just compensate the originator for expenses. If the estimated income from the loan for the time it would be held were worth more to the originator, or to other potential loan holders, than 101 percent of the face value, then the option would have a positive value. The government's selling the option would recoup those excess returns.

EFFECT ON PROGRAM STRUCTURE

Under this mechanism, most aspects of FFELP could remain unchanged. As is generally true of the other models discussed in the body of the report, the federal government could provide special allowance payments if deemed desirable as an addition to the lenders' return from a maximum statutory student interest rate, and loans would remain guaranteed lenders. Lenders would originate and service loans, and schools and borrowers could continue to choose their loan originator. Additionally, loan originators could continue to compete for loan volume through decreased interest rates and fees to students.

EFFECT ON BORROWERS

Financial benefits to students would remain unchanged or might increase under this model. It is unlikely that benefits to borrowers would decrease, because concessions by lenders would be a way of getting additional business; they would not be required to bid in advance for the additional loans. The concession to borrowers would diminish the likelihood that they would have to bid for the option to retain the loan.

The model could permit differential concessions to student borrowers but would not require differential student rates to ensure loan availability. Availability of loans to all borrowers could be assured in one of several ways: (1) The special allowance payments and interest rates would provide a return adequate to service the most-expensive-to-service loans, (2) The government could exercise the options on loans expensive to service and resell the loans at a loss, or (3) This model could be supplemented (as suggested for other models discussed above) by a lender of last resort or administrative requirements on FFELP lenders.

In a completely private exchange market, all options would not be sold for the same price, even apart from discounts to students. Because some loans are cheaper to service than others, as discussed earlier in this report, it would be expected that options on these loans would sell at a higher price. Where the government is on one side of the transaction, it would be desirable to bundle options by loan characteristic in order to allow for price variations to parallel these cost variations. The same issues of design of option bundles would emerge as would arise in the rights auction model. The possibility of private transactions and bundling of government sales could mean that, unlike the current system in which special allowance payments provide a one-size-fits-all gross return, this option model could produce more efficient incentives of all types of loans, without necessitating excess net returns for cheap-to-service loans.

BUDGETARY EFFECT

While it is unclear whether the government would realize any budgetary savings under this model, federal costs are not expected to increase. Any potential excess lender profits after the exercise date of the options would either be provided to students in the form of discounts or recouped by the federal government in the option price.

EFFECT ON LENDERS

The model would likely decrease or maintain existing lender returns in the aggregate. It is unlikely that overall lender returns would increase. Rather, if bundling of options by loan characteristics could be done effectively, the model would foster an environment where income would more closely match the characteristics of the loan. Loans with higher servicing costs (lower estimated value) would demand lower call option prices.

The originator of a loan might have a slight advantage in bidding on the options, because he or she would not bear the burden of exercising the options and loading the loans on his or her own, different loan servicing system. Combined with existing arrangements through which lenders essentially extend a line of credit to students for their course of study at a particular school, this advantage would tend to keep a student's loans with a given servicer. This would be efficient for both servicer and student. The existing possibilities for loan consolidation also need not be disturbed in this model.

MODEL CONSIDERATIONS

One key component of this program would be the call option exercise price—that is, the price at which the government would have the right to acquire the loans. It should be established near the cost to originate student loans. If the exercise price were too low, loan originators would not participate. If the exercise price were too high, there would not be bidders for the options. The government would be required either to let them expire (leaving loans with the originators, who might earn an excess return) or to exercise the option and resell the loans at a loss (albeit, probably a small loss unless the error on the exercise price was quite large).

The costs related to loan origination are very similar among all student loans, regardless of delinquency or balance. Measuring the cost of origination would require obtaining information that is readily available about certain fixed and variable costs. The origination allowance built into the exercise price could be a fixed amount of dollars per loan plus a percentage of the borrower's principal balance. Because many originators of student loans are not the ultimate holders, contracts with secondary marketers could also provide a source of information on origination costs. In contrast, when the Congress (or its designee) is evaluating the net return associated with a given SAP, it must measure a wide range of lender costs: servicing costs over the likely 10-year life of loans, the effects of differing loan balances, the likelihood of default costs, and the likelihood that loans will be prepaid or consolidate. It should be much easier to determine the market cost of originating student loans than to determine the market rate of return for loans over their life, taking these other costs into account.

Another key design decision involves determining the call option availability period (the time when the option can be exercised). Lender uncertainty regarding the option could be considerably reduced if the option first became effective near the time when originators now most frequently sell many student loans. This might be just as the loan entered repayment. Alternatively, the effective period for the option might be set earlier, if it were thought that a substantial portion of any excess profits on loans were received early in the life of the loan. In either case, it would seem desirable for the option to have a fixed expiration date, without an excessively long window in which it could be exercised.

APPENDIX VI

ADDITIONAL AND DISSENTING VIEWS FROM RENE CHAMPAGNE

This appendix presents an additional and dissenting view submitted by study group member Rene Champagne in accordance with section 801(d) of the Higher Education Amendments of 1998.

Received by e-mail December 12, 2000.

> I am particularly concerned with any proposal that attempts to segregate federal student loans by type of student or by type of institution because of the inherent opportunity for discrimination provided under such formulas. Title IV programs have been created by Congress to insure equal access to postsecondary education for all students regardless of race, ethnic background, gender or income level assuming the student met certain eligibility standards applied uniformly to all students. The same holds true for institutions. Congress has made it very clear that they will not tolerate the segregation of institutions reflected but their support of Historically Black Colleges, Career Colleges and Schools and Community Colleges as well as traditional four-year institutions. I fear segregation by student type and institution type as contained in certain proposals borders on "redlining" and therefore must be avoided. "Blended" portfolios must continue to be used in the future to insure that all students are properly afforded equal access to the institution of their choice.

APPENDIX VII

ADDITIONAL AND DISSENTING VIEWS FROM MICHAEL HERSHOCK AND RICHARD PIERCE

This appendix presents an additional and dissenting view submitted by study group members Michael Hershock and Richard Pierce in accordance with section 801(d) of the Higher Education Amendments of 1998.

January 16, 2001

Dear Reader:

Attached is a paper entitled "Today's Competitive Loan System Is Already Filled with Market Mechanisms," prepared in our capacity as Members of the Market Mechanisms Study Group. We were assisted in the preparation of the paper by Harrison Wadsworth of the Education Finance Council.

We have requested that this paper be appended to the report of the study group because we believe that the paper presents a viewpoint that is not thoroughly explored in the body of the study group report. It is our hope that this paper will assist readers in better understanding the market forces currently at work in the Federal Family Education Loan Program.

The presentation of this paper is not intended as a dissenting view, nor should its presence in the report's appendix be interpreted as representing any particular characterization of the study group report.

Michael H. Hershock
President and CEO
Pennsylvania Higher Education
Assistance Agency

Richard H. Pierce
President and CEO
Maine Education Services

Today's Competitive Loan System Is Already Filled With Market Mechanisms

A proposal prepared for the Study Group On Market Mechanisms In Federal Student Loan Programs

Prepared by: Richard H. Pierce
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May 5, 2000

Today's Competitive Loan System Is Already Filled With Market Mechanisms

We recommend that one of the three or more systems of market mechanisms included in the General Accounting Office/Department of Education report to Congress under Section 801 of the Higher Education Amendments of 1998 should be the current student loan system. The current system involves intense competition for business among thousands of private organizations, with additional competition from state government agencies and the federal Direct Loan program.

Under any scenario that preserves the basic mission of the Higher Education Act, Congress will always be involved in setting prices for at least some segments of borrowers. We believe the alternative is unacceptable — reducing access to higher education for students. Today's prices are ceilings, which Congress could lift if it wished. Given the level of competition, prices of loans for most borrowers might not rise. Prices for some categories of borrowers probably would — such as borrowers attending high-default schools with low loan balances. Any federally supported student loan system will always have intensive Congressional oversight. No system is perfect. Imperfection will always invite attempts at improvement by lawmakers and administrators.

Market mechanisms currently exist in every aspect of the FFEL Program.

Loan origination: Lenders compete to offer schools the fastest, most efficient, most reliable origination of loans. Students demand this, and school financial aid administrators in turn also demand the best quality service. Loan delivery must be accomplished within hours of the receipt of an application. Anything more will send students and schools elsewhere. A characteristic of the FFEL Program is that there are many alternatives. Once a school has entered direct lending, the only choice if there are service problems is to convert to FFELP, a process that requires the school to forsake the investment it has made in systems that process direct loans. The federal government should not take steps to make FFELP more like direct lending, winnowing participation down to a few huge players offering basically the same products, leaving schools and borrowers with few choices.

Loan Servicing: Private lenders must follow due diligence procedures in servicing loans or they lose the 98% federal guaranty. Some lenders, such as EFC members, only exist to make student loans. If they displease students and schools, they will be out of business. Even in large diverse lending organizations, the student loan department is usually a specialized area where the jobs of its employees depend on success in student lending.

In addition, a number of financial considerations motivate lenders of all types to provide top quality service, in addition to the necessity of complying with federal regulations. Lenders not only lose 2% of their principal when loans default. They also have cash flow issues, because they have to keep repaying their investors whether or not they are receiving payments on the underlying loans. When a loan defaults, there is a delay before insurance is paid, causing cash flow problems that, if severe, could cause a default on bond payments. Bond issues are structured with reserves and other methods to make a default highly unlikely for the majority of an issue. This brings a high rating from credit rating agencies, reducing borrowing costs. Low borrowing costs translate to low interest rates, lots of competition for business, including borrower benefit programs for students and their families. One of the key factors that rating agencies check is the track record of the company that will service the student loans that form the collateral for a securities issue.

High quality loan servicing holds a rank of highest importance in the federally backed loan programs. The penalties for problems are severe. Borrowers are tracked down and punished by seizure of income tax refunds, wage garnishment, lawsuits, loss of professional licenses and destruction of credit ratings. Bankruptcy usually doesn't help since a student loan generally cannot be discharged. Schools face bad publicity at a minimum and closure at a maximum if their students' default rates rise too high. Guaranty agencies lose money at increasing rates if their borrowers' default rates rise too high. The Education Department and Congress face the wrath of the public and a potential loss of confidence in the loan programs if default losses rise again, like they did in the late 1980's. In other words, everyone involved in the loan program has an incentive to make sure that if a loan does default, it is not because of servicing problems. There are strong incentives to do everything possible to avoid loan defaults and to cure them if they do default.

Liquidity: As loan volume has grown in recent years, there never has been a problem with finding adequate funds for college. A healthy secondary market for loans ensures liquidity in the student loan market. That means that funds are available at reasonable cost. As it has become apparent that the FFEL Program will survive and grow, more investors, including international investors, have been willing to invest in student lending. This is good for American students. It shows the health of the loan program. It is something that should be encouraged. Proposals that disrupt the system or cause uncertainty and instability will result in reduced interest in investing the tens of billions of dollars needed every year to finance student loans. At a minimum, this loss of liquidity will increase lending costs, meaning more money will go into paying off bonds, leaving less for improvements in technology and for borrower benefits.

Subsidies for Borrowers: Subsidies from various sources are in place to help reduce borrowers' costs. As a result, student loans are some of the lowest cost loans available anywhere. The federal government has put a ceiling on interest rates and capped that ceiling to make sure they stay low. The government lowers rates further by paying interest for borrowers at various times. Lower-income borrowers have their Stafford Loan interest paid while in school and during periods of deferment. All borrowers, including parents, are guaranteed that their interest payments will not rise above a low level, no matter what the Federal Reserve does. These caps have saved borrowers millions of dollars. Recent Stafford Loan borrowers have a portion of their interest costs — 0.5 percentage point — paid by the government at all times. On top of that, interest payments are deductible from federal income taxes for many borrowers. The combination of subsidies leaves a net interest cost for subsidized Stafford loans of less than 4% — the lowest-cost consumer loans available. On top of that, most borrowers can reduce their costs even further thanks to lender-offered borrower benefits programs. The system is set up to keep borrowing costs as low as possible.

Access: Much of the discussion of market mechanisms in the student loan programs and of ways to set interest rates seems to ignore the fundamental purpose of the federally backed student loan programs — to ensure that all Americans have a way to pay for higher education. A corollary purpose of the programs, also important, is to keep the cost of borrowing as low as possible. There are various philosophical points of view about borrowing. Some, including many in other countries, believe that the nation should provide a higher education to all who wish it or all who qualify. For many years, the state of California followed that policy, not charging tuition to in-state residents attending state universities, although significant "fees" were charged. Others believe that governmental assistance to pay for higher education should be concentrated on students with the greatest need. Another approach treats assistance as a reward for students who demonstrate merit. Policy in the United States has included all three approaches, with need-based aid the predominant approach since 1965. Increasingly in recent years, states and schools have put resources into merit-based grant aid. But the loan programs have always been either based on need or open to all, without regard to grades or other merit factors. Given the trend towards merit-based grants, the FFEL Program will become more critical to ensuring that every American can pay for college. Whether this trend changes or not, this country will need a large loan program for the foreseeable future.

Summary and Conclusions: Experimentation with massive restructuring of the FFEL Program could threaten its viability. Any major changes must be weighed against the strength of the existing program. The best decision for Congress may be to do nothing rather than continuing the turmoil that has kept program participants on edge for the past 10 years. Constant upheaval is costly and eventually wears down loan providers, financial aid administrators, and others who are involved in the loan programs. Competitive pressure and the technological revolution of the 1990's have brought significantly reduced borrowing costs for students, their families and taxpayers. This is a good thing. It should be encouraged.

Competition with direct lending is no longer a central issue for lenders, although the competition with FFELP does seem to be a major concern for schools in the Direct Loan Program. Lenders are much more focused on doing battle in the marketplace with their FFELP competitors.

Currently, the largest lenders are increasing market share. Still, the smaller state and regional lenders serve to provide alternatives to the big national companies, keeping prices low and service high. Many times they are able to meet local needs and provide specialized service to schools thanks to longstanding relationships. This allows customization of products to fit the needs of particular schools, particular students and particular states. It would be a mistake to encourage development of an effective cartel or oligopoly by altering the loan program so that only the largest participants remain viable.

Beware of arguments about competition being "unfair." Such statements always suffer from tunnel vision -- only looking at one of many factors that affect the competition. For example, should it be considered unfair for an organization to have access to interest-free funds? Is it unfair for one company to be able to offer its student loan customers other financial products that a competing company (or program) cannot offer? Probably not.

Student loan programs should not be dumbed down, with the federal government picking the lowest common denominator for loan programs and forcing everyone else to reduce their services and raise their prices to that level. The program should remain flexible enough to encourage excellence, innovation and the use of the latest technology.

Market mechanisms already dominate the way prices are set and services are provided in today's FFEL Program. Any study of market mechanisms should include a look at how competition works in today's program, which is effectively delivering $22 billion in new loans this year while servicing a $150 billion portfolio with increasing efficiency and decreasing defaults.

APPENDIX VIII

ADDITIONAL AND DISSENTING VIEWS FROM PAUL TONE AND RICHARD PIERCE

This appendix presents an additional and dissenting view submitted by study group members Paul Tone and Richard Pierce in accordance with section 801(d) of the Higher Education Amendments of 1998.

April 2000

Student Loan Auctions: Issues and Implications

A Briefing Paper
Submitted by USA Group

USA Group gratefully acknowledges the contributions of the following organizations in the preparation of this paper:

Consumer Bankers Association
Education Finance Council
National Council of Higher Education Loan Programs
Pennsylvania Higher Education Assistance Agency
Sallie Mae

Student Loan Auctions: Issues and Implications

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Student Loan Auctions: Issues and Implications

Executive Summary

Background. Representatives of the financial aid community are exploring options for using an auction system or other market-based mechanisms to determine interest rates and subsidy levels for federal education loans. Their congressionally mandated goal is to evaluate whether a market-based model could reduce the cost of loans to students, parents, and taxpayers and, at the same time, maintain high-quality services for *all* borrowers and schools.

The findings of the task force could fundamentally alter the delivery of federal education loans, which are now the nation's single largest source of financial aid. During the 1999-2000 academic year, federal loans are expected to reach a record $36 billion, including $24 billion in guaranteed loans issued by private lenders under the Federal Family Education Loan Program (FFELP). Nationwide, lenders will issue more than 5 million loans--each averaging in excess of $3,500--to students attending thousands of schools ranging from community colleges to exclusive private institutions to small vocational schools to huge state universities.

Congressional interest in an auction system stems from a desire to reduce the federal subsidy to the loan program and thus help shrink federal budgetary outlays. Some lawmakers contend that an auction will spur lenders to lower the cost of loans to students. An added bonus is eliminating the political headache created when Congress tries to dictate interest rate formulas from Capitol Hill. Lawmakers mandated the auction study in as part of the Higher Education Amendments of 1998.[1] This legislation authorized the continuation of the Higher Education Act, which established the federal loan program in 1965. The amendments included a revision in the formulas used to set interest rates for Stafford loans for students and PLUS loans for parents. Without the change, a rate formula scheduled to take effect in July 1998 was expected to drive virtually all lenders out of the federal loan program.

Objectives of the Auction Study. According to the conference report for the 1998 HEA legislation, the Comptroller General and the Secretary of Education are required to appoint a study group "to identify and evaluate means of establishing a market mechanism for the delivery of Title IV loans." The legislation stipulates that at least three different mechanisms must be proposed and analyzed. The group is to submit its preliminary findings by mid-November 2000 and file its final report no later than May 15, 2001.

Congress did not specify the market mechanisms to be studied but did establish at least a dozen criteria to be used in the evaluation. These include how such mechanisms would affect the following: interest costs borne by student and parent borrowers; the federal budget; the distribution of federal subsidies to loan providers; the regulatory burden for students, institutions, lenders, and other program participants; efforts to reduce student loan defaults; and the market incentives needed to encourage improvements in service quality.

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[1] Public Law 105-244.

Congress also required the study group to be representative of lenders, other participants in the federal loan programs, financial service providers, and the financial aid community.

Objectives of the Federal Loan Program. The evaluation criteria stated above clearly indicate that Congress intends to determine whether a market-based mechanism can increase the efficiency of Stafford and PLUS loans *without* sacrificing four key policy goals that form the cornerstone of the federal education loan program today. These goals are as follows:

1) **Provide universal access to higher education by ensuring that any eligible student is able to obtain a federal education loan, regardless of the borrower's socio-economic status or choice of school.**

2) **Make federal loans available at the lowest possible cost to borrowers.**

3) **Protect taxpayers' fiscal interest by minimizing the cost of default.**

4) **Improve the student loan delivery system by simplifying the loan process; reducing paperwork and regulatory burdens on students, parents, schools, loan providers; and encouraging high-quality customer service.**

Existing Auction Models. Several federal agencies use auctions to sell assets or the rights to provide products and services to consumers. The best known auction of financial assets is probably the Treasury Department's sale of Treasury bills. Military surplus, real estate, and a variety of consumer goods, including personal property seized by law enforcement agencies are sold to the public via auction. Washington uses a variety of bidding processes to sell the *rights* to cut timber, sell infant formula, extract oil from petroleum reserves, and provide wireless communication services. Only a few agencies have used auctions to sell loans or the right to make loans. The Department of Housing and Urban Development, for example, has auctioned defaulted mortgages, and the Department of Health and Human Services (HHS) held auctions to select lenders under the Health Education Assistance Loan (HEAL) program.[2]

The HEAL Auction Experiment. The HEAL loan auction is sometimes offered as a model for a FFELP auction. In 1992, lenders began competing under a single-round auction process to win the right to make loans to students pursuing degrees in 11 different health professions. The performance review of the HEAL auction is mixed. Although the auction generated a steady downward trend in HEAL rates, annual shifts in the roster of winning bidders for new HEAL loans forced many, if not most, medical schools to withdraw from the HEAL program.

FFELP Auction Options. Just how would a FFELP auction work? Industry analysts have offered numerous possibilities, but most are variations of a type of auction known as a rights auction. Bidders, for example, could be invited to bid on the right or rights to make a specified amount of loans to a particular group of borrowers during a particular time frame at a pre-determined price. A key issue is how to establish a system that guarantees ready access to loan funds by borrowers, regardless of the type of institution they attend or where they reside, and, at the same time, lowers the subsidy cost to taxpayers. Would a sufficient number of lenders be willing to supply loans to high-default proprietary schools that serve economically disadvantaged students? If the auction process radically reduces the number of players to just a few big lenders, would they be able to originate loans anywhere in the U.S.? At present, no one lender truly markets nationwide. Another key issue: Can an auction process offer sufficient incentives to ensure a high level of service quality and investment in technology needed to improve service delivery?

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[2] "Competitive Financing Mechanisms: Auctions Used by Federal Agencies" was published in a letter to members of the House Education and Workforce Committee. GAO document citation: *GAO/HEHS-99-57R Federal Auctions*.

Another possibility would be an auction of the actual loans. This option is mentioned because it would provide a mechanism to mesh the Federal Direct Loan Program (FDLP) with the FFELP. In the FDLP, the Department of Education is the lender and holder of loans. Under an auction model, the government could sell these loans to lenders, secondary markets or other private entities either prospectively or after the loans are made. Some analysts have suggested that FFELP loans could be originated by a single entity—presumably the Department of Education—but then auctioned to the highest bidders, which would then be responsible for servicing the loans and bearing default costs. Would-be purchasers would factor the future cost of funds, servicing expenses and default losses into their bids. Although this approach could simplify the loan origination process, it could also result in shifts in loan servicing arrangements. In addition, the government is not guaranteed that it could receive an acceptable price, especially if only a few lenders or secondary markets submit bids.

Both rights auctions and loan auctions are deceptively simple in concept. In practice, both models require complex structures that must address numerous policy concerns and operational issues, including the frequency of auctions, bidding procedures, and bidder eligibility rules. The full report provides a guide to key structural components of both types of auction models.

Long-Term Implications of a Student Loan Auction. Clearly, an auction process might help lower the cost of federal education loans over the short-term. Long-term, however, an auction approach is likely to reduce the number of market participants, since losing bidders may decide to quit the business permanently. The resulting exodus of bidders and turnover in loan providers could quickly erode the quality of services to borrowers and schools.

A decline in the number of market players will eventually reduce the competitiveness of the auction. Fewer players mean bigger players, raising the costs and stakes of trying to enter or re-enter the market. As the number of bidders dwindles, so does the pressure to hold the line on costs and lender-yield requirements. The remaining bidders would have little incentive to improve service quality or invest in new technologies. Eventually, borrowers could pay higher rates and taxpayers higher subsidies for stagnating service levels.

Moreover, auctions are likely to disrupt the student loan delivery system. Losing bidders could be abruptly shut out of the program. Such dislocations force borrowers and schools to locate new sources of funds. Change would be the result of shifting lender relationships rather than innovation. Although measures could be implemented to increase the number of bidders or enhance loan terms, such steps tend to increase program costs and complexity and thus undercut the benefits of an auction pricing system.

The FFELP: A Market-Driven Alternative to Auctions? Most advocates of student loan auctions contend that the current guaranteed loan program is not "market-based" and that only an auction would establish a truly fair price for the government to pay to induce lenders to make loans. Yet, today's FFELP lenders vigorously compete for student loan volume.

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By most accounts, lender competition based on service became fierce at least 10 years ago, well before the enactment of the Federal Direct Loan Program in 1993. During this period, FFELP loan providers developed and implemented continuous improvements in loan delivery systems and servicing standards, notwithstanding the absence of any federal requirement to do so. For example, millions of dollars have been invested in sophisticated automated account inquiry services borrowers can access via telephone or the Internet. The Web sites of lenders, loan servicers and guarantors offer dozens of calculators and other interactive counseling resources. Over the last five years, lenders intensified their efforts to win customers by increasing the focus on price. Today, competition based on the cost of loans to borrowers is virtually universal. Clearly, students and parent borrowers are the primary beneficiaries of these free-market initiatives, and a recent government survey shows that the FFELP is enjoying strong gains in customer satisfaction among schools and borrowers.[3]

Conclusion. In general, the myriad questions voiced regarding the structure and outcomes of student loan auctions focus on how to protect the interests of schools, students, borrowers, and taxpayers and foster competition. Policymakers can choose among dozens of alternative auction concepts for structuring the bidding process, including models designed to address school concerns about retaining lender choice. Still, in many instances, addressing auction implementation issues would require the development of special rules and procedures or the creation of a management/oversight function within the U.S. Department of Education. As policymakers and Congress consider the issues, they should ask whether the negatives associated with an auctionXincreased complexity, abrupt changes in loan providers, and eventual deterioration in competition with subsequent deterioration in price and service levelsXoutweigh the benefits.

Thus, any serious consideration of "market-based mechanisms" must start with a disciplined examination of the policy goals that underpin the federal student loan programs. The study group should not only evaluate new market-mechanisms against these objectives, but also should assess the current guaranteed loan program's track record in achieving national policy goals. This discovery process could demonstrate that more could be lost than gained by a precipitous move to an auction system that radically alters the diverse incentive structure that drives FFELP loan providers to serve all eligible borrowers at ever increasing levels of service and price benefits.

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[3] "Direct Loan Program Administration, 1993-1998," Macro International, under contract to the U.S. Department of Education.

Student Loan Auctions: Issues and Implications

Introduction

Representatives of the financial aid community are exploring options for using an auction system or other market-based mechanisms to determine interest rates and subsidy levels for federal education loans. Their congressional mandate is to evaluate whether a new means of determining lender return on student loans should be adopted. The group will examine at least three different "market mechanisms" that are conducive to advancing the basic objectives of the program, including the availability of loans for all eligible students.

The study is required under the Higher Education Amendments of 1998.[4] It was included in the legislation following a lengthy debate on how to minimize the cost of loans to borrowers without incurring unnecessary federal subsidies. Congress approved the study after rejecting a proposal to test one or more auction mechanisms on a limited basis, under a pilot project, and after a lengthy and sometimes heated debate on the appropriate level of the federal payments made to lenders under the FFELP.

If adopted into law, the findings of the task force could fundamentally alter how students obtain federal student loans and how education loans are administered on campus. Student loans are now the nation's single largest source of financial aid for higher education. During the 1999-2000 academic year, federal loans are expected to reach a record $36 billion, including $24 billion in guaranteed loans issued by private lenders under the Federal Family Education Loan Program (FFELP). Nationwide, lenders will issue more than 5 million loans, each averaging in excess of $3,500 to students attending thousands of schools, ranging from community colleges to small vocational schools to exclusive private institutions to huge state universities.

In light of the study's importance, members of the higher education community are expected to participate actively in the task force deliberations and the drafting of recommendations. This paper is intended to identify some of the central issues involved in implementing one of the market-based mechanisms the group is expected to examine: **student loan auctions**.

Background

Congressional interest in an auction system stems from lawmakers' desire to provide students and other borrowers with the least costly loans possible and, at the same time, ensure universal availability and high-quality service to students, borrowers, and schools. The three objectives—optimal cost, availability, and service—have been and remain somewhat in conflict with each other. Low-cost student loans have traditionally required substantial federal subsidies to borrowers and loan providers (in the guaranteed student loan program). Assuring universal availability of loans and high service levels requires considerable investment in human and capital resources. The study group's mandate, in essence, is to determine whether the market mechanisms currently used to establish price and service levels in the student loan program could be changed to reduce costs to the government while continuing to serve all eligible students.

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[4] Public Law 105-244.

Some lawmakers contend that an auction will spur lenders to lower the cost of loans to students. Others believe an auction would somehow "simplify" the student loan programs. Still others expressed an interest in an auction as a means of ending the periodic political headaches that arise when Congress tries to dictate interest rate formulas from Capitol Hill.

The decision to conduct the market-mechanisms study reflects, in part, the frustration of Congress created by the budget and policy challenges involved in addressing FFELP interest rate and lender return issues during the 1998 reauthorization of the Higher Education Act. One of the greatest challenges facing Congress in 1998 was finding a way to modify the interest rate formula to reduce the cost of the guaranteed loan program, yet, still provide sufficient lender yields to assure the continued availability of loans after July 1, 1998. Under legislation enacted in 1993, the base rate used to calculate federal loan rates was scheduled to change in mid-1998, from a short-term Treasury bill index to a long-term government bond index. Providers of guaranteed student loans argued that the economic impact of this change would make their continued participation in the program impossible.

In exploring solutions to this problem, lawmakers faced significant budget constraints. Under the Congressional Budget Act, projected expenditures for student loans were strictly limited. Because prevailing financing conditions made amending the formula for lender returns costly, Congressional frustrations ran high. Bipartisan efforts in both the House and Senate to simultaneously reduce the cost of loans to borrowers below the levels then in effect compounded the difficulty.

Efforts to resolve the issue were structured to provide student loan borrowers with the same level of interest rates expected to take effect under the scheduled change in the rate formula. To achieve this goal within the limits set under the Budget Act, federal payments to guaranteed loan providers would have to be minimized. Throughout the debate, lawmakers bemoaned the inherent difficulty in determining a "fair-market" return for lenders, as noted in the following excerpt from a February 1999 report published by the General Accounting Office:

> Throughout the history of the FFELP, and especially over the past year, debate over [the rate] formula has centered on whether lenders' profits have been excessive—at the expense of college students, their families, and taxpayers. Lenders have claimed that recent proposals to reduce the interest rate they receive would force them to end their participation in the FFELP. Studies by the Department of the Treasury, the Congressional Budget Office (CBO), and the Congressional Research Service (CRS) have reached differing conclusions about the extent to which lenders could bear a reduction in their interest rate and still continue to earn reasonable profits. As a more recent CBO study noted, the federal government lacks information regarding the costs FFELP lenders incur through their participation. Consequently, the current rate-setting formula may result in some lenders earning higher profits than necessary to secure their participation. However, if the government were to make a significant cut in the lenders' rate and some lenders decided not to participate in the program, the supply of loans might be reduced, perhaps to the point of being insufficient to satisfy the borrowing desired by students.[5]

The 1998 reauthorization process concluded with the enactment of the Higher Education Amendments of 1998, which authorized the continuation of the two major student loan

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[5] "Competitive Financing Mechanisms: Auctions Used by Federal Agencies" was published in a letter to members of the House Education and Workforce Committee. GAO document citation: *GAO/HEHS-99-57R Federal Auctions*

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programs administered by the U.S. Department of Education for the next five years. In this legislation, Congress addressed the immediate lender return issue by extending the then-current provisions—and reducing the subsidy to lenders—through June 30, 2003. Congress also mandated the market-mechanisms study. The results of the study may help guide Congress in designing a new mechanism for determining lender yield when lawmakers address what some policy analysts have already dubbed the "2003 Interest Rate Problem." A brief history of recent changes in Stafford and PLUS loan interest rates is provided beginning on page 25.

Objectives of "Study of Market Mechanisms in Federal Student Loan Programs"

Under section 801 of the Higher Education Act, the Comptroller General and the Secretary of Education are required to convene a study group "to identify and evaluate means of establishing a market mechanism for the delivery of Title IV loans." The legislation stipulates that at least three different mechanisms must be proposed and analyzed. The group must submit its preliminary findings by mid-November 2000 and file its final report no later than May 15, 2001.

Congress did not specify the market mechanisms to be studied but did establish the following criteria to be used in the evaluation:

1) The cost or savings of loans to or for borrowers, including parent borrowers.

2) The cost or savings of the mechanism to the federal government.

3) The cost, effect, and distribution of federal subsidies to or for participants in the program.

4) The ability of the mechanism to accommodate the potential distribution of subsidies to students through an income-contingent repayment option.

5) The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants.

6) The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower.

7) The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders.

8) The effect on program integrity.

9) The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans.

10) The availability of loans to students by region, income level, and by categories of institutions.

11) The proposed federal and state role in the operation of the mechanism.

12) A description of how the mechanism will be administered and operated.

13) Transition procedures, including the effect on loan availability during a transition period.

14) Any other areas the study group may include.

Congress also required the study group to encompass representatives of lenders, other participants in the federal loan programs, financial service providers, and the financial aid community.

Objectives of the Federal Loan Program

The study group is directed to identify no fewer than three different market mechanisms for determining lender return "while continuing to meet the other objectives" of the student loan programs. The mandate for the study does not specify what these objectives are. Within the higher education community, these objectives are widely seen as including the following:

1) **Providing universal access to higher education by ensuring that any eligible student is able to obtain a federal education loan, regardless of the borrower's socio-economic status or choice of school.**

2) **Making federal loans available at the lowest possible cost to borrowers.**

3) **Protecting taxpayers' fiscal interest by minimizing the cost of defaults.**

4) **Improving the student loan delivery system by simplifying the loan origination and repayment process; reducing paperwork and regulatory burdens on students, parents, schools, and loan providers; and ensuring high quality customer service.**

Universal access. The most constant objective of the federal student loan programs since the original enactment of the Higher Education Act in 1965 has been to assure that every eligible student, as defined by Congress, has access to student loans. Congress has defined borrower eligibility broadly. The definition now encompasses students attending traditional four-year colleges and universities, as well as students enrolled in short-term courses at career, junior, and community colleges. Moreover, Congress recently recognized the increasingly important role of the Internet in delivering higher education, by expanding the definition of eligibility, on a pilot basis, to students enrolled in distance-education programs.

Consistent with the universal availability of loans is the companion objective of ensuring similar loan terms for all students. Notwithstanding significant differences between the types of borrowers receiving loans, borrowers have received the same repayment terms, interest rates, and deferments. In a given financial aid award year, for example, a student enrolled in a truck-driving school in a rural community pays the same interest rate as a student pursuing a professional degree at an Ivy League university.

Many believe Congress is unlikely to favor a system that establishes different rate terms for different categories of students. Multiple rate structures could result if, under a student loan auction, lenders are allowed to bid a lower rate for students attending low-default schools, which typically are four-year universities or graduate schools, and higher rates for students attending high-default schools.

The goal of universal access entails more than simply making loans available on demand. Lawmakers have generally insisted, too, that borrowers enjoy the freedom to select their lenders. Continuity of access is also important. Borrowers generally want to obtain all of their education loans from the same lender, thus centralizing their accounts and minimizing paperwork hassles.

Minimizing cost to borrowers. Over the years, Congress has made a series of adjustments in student loan interest rates to minimize costs to borrowers, while still maintaining lender participation. (See rate history on page 25). Lawmakers also aided students by outlawing prepayment penalties and by limiting the frequency of interest capitalization. Still, the lender's return has always been part of the interest rate equation. To promote widespread lender participation, Congress has adjusted subsidies to ensure that lenders receive a sufficient market return.

On some occasions, Congress actually increased the cost of student loans when pressured to do so under fiscal budget procedures. One such instance occurred in 1981, with the enactment of borrower-paid loan origination fees. History shows, too, that Congress has reversed increases in the cost of loans when budgetary conditions permitted doing so. Indeed, strong bipartisan support for reducing the cost of student loans was a major theme of the debates surrounding 1998 reauthorization of the Higher Education. As a result, the final provisions of the 1998 reauthorization produced some of the lowest borrower loan costs in recent years.

Minimizing default costs. Defending against defaults is deemed critical to maintaining the integrity of the federal loan programs. Although student loans are expected to experience higher default rates than other consumer loans, default costs must be controlled to keep the program's costs manageable. In the late 1980s, soaring default rates, coupled with skyrocketing loan volume, prompted a crackdown on fraud and abuse. Anti-default measures enacted by Congress include termination of federal loan eligibility for schools that experience high cohort default rates over a three-year period.

Since the early 1990s, the national default rate on guaranteed loans has been cut by more than 60 percent—to less than 9 percent. Many industry observers credit much of this reduction to default avoidance programs instituted by guarantors and other loan providers. Significant improvements in loan servicing systems, which today are likely to include instant, on-line access to borrower account information as well as interactive counseling resources, are also credited with helping to reduce default rates. The evaluation criteria for the study group include both the "effect on program integrity" and "the degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans." Both may be considered relevant to the objective of minimizing default costs.

Enhancing service delivery and quality. This policy objective can be viewed, in part, as a reaction to the rule-laden complexity of the current federal loan programs. A patchwork of major and minor legislative changes have been enacted over the course of 35 years to expand student and school eligibility, liberalize repayment terms, defend the program against fraud and abuse, protect borrowers' rights, and reduce defaults by imposing sanctions against borrowers, schools and lenders. As a result, issuing and servicing student loans is more complicated than administering other types of consumer credit.

In recent years, lawmakers have explored ways to simplify the student loan program to ease regulatory burdens on schools and loan providers, and to make it easier for students to manage their growing student debt burdens. For example, among the steps taken by Congress in the 1998 reauthorization was a directive to modernize the Department of Education's Office of Student Financial Assistance and the data systems used to support the federal student aid programs. Not surprisingly, one of the study group's criteria for evaluating market-based mechanisms is their "effect on the simplicity of the program."

The study group must also evaluate the effect of market-based mechanisms on present and future investments in "human capital and resources, loan servicing capability, and quality of service to the borrower." Clearly, Congress recognizes that improvements in the delivery and quality of education loan services depends on the ability of loan providers to enhance delivery systems by investing in new technologies and by attracting competent, well-trained employees.

Existing Auction Models Used by the Federal Government

Several federal agencies currently use auctions to sell assets or the rights to provide products and services to consumers. The best known auction of financial assets is probably the Treasury Department's weekly sale of Treasury bills. Military surplus, real estate, and a variety of consumer goods, including personal property seized by law enforcement agencies, are sold to the public via auction. In addition, Washington employs a variety of bidding processes to sell the *rights* to cut timber, sell infant formula, extract oil from petroleum reserves, and provide wireless communication services.

According to the February 1999 GAO report, only a few agencies have used auctions to sell loans or the right to make loans. The Department of Housing and Urban Development, for example, has auctioned defaulted mortgages, and the Department of Health and Human Services (HHS) held auctions to select lenders that could issue loans under the Health Education Assistance Loan (HEAL) program.[6] Most recently, the Small Business Administration has proposed using an auction in connection with loans administered by the agency.

The HEAL auction experiment. The most frequently cited example of how an auction mechanism might work in the federal student loan programs is the HEAL loan auction implemented by HHS. In 1992, lenders began competing under a single-round auction process to win the right to make loans to students pursuing degrees in 11 specified health professions. Lenders could bid for the right to make loans for all or a portion of a particular discipline (medicine, veterinary medicine, etc.). Lenders could also bid for the right to make loans in a particular state or to students attending a specific school. Lenders submitted sealed bids stating the interest rates they would charge while borrowers were in school, deferment, grace, or repayment.[7]

The performance review of the HEAL auction is mixed. Although the auction generated a steady downward trend in HEAL rates, annual shifts in the roster of winning bidders for new HEAL loans forced many, if not most, health-professions schools to withdraw from the HEAL program. Medical schools found themselves constantly having to alter their loan delivery systems to accommodate the change in lenders. A constantly shifting mix of lenders requires system changes, and thus extra expenditures of time and money. Financial aid administrators worry, too, that frequent shifts in lenders could undermine default prevention efforts, noting that borrowers had trouble tracking how much they owed and to whom. Indeed, some industry observers note that perhaps the only reason the HEAL auction process worked at all is that more than 80 percent of HEAL loans were purchased by a single secondary market, preventing many borrowers' loans from being split among multiple loan servicers.

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[6] *GAO/HEHS-99-57R Federal Auctions*

[7] *GAO/HEHS-99-57R Federal Auctions*

The limited experience of the HHS program makes it difficult to determine whether the HEAL auction process could be successfully applied to the FFELP. The HEAL auction lasted only a half-dozen years. Largely because the HEAL program suffered heavier-than-expected default costs (although HEAL default rates are substantially lower than Stafford default rates), Congress began a phase-out of the HEAL program in 1996. Since then, new HEAL loans could be issued only to existing HEAL borrowers. To offset the demise of HEAL, Stafford loan limits were increased substantially for students in health professions.

Moreover, the scope of the HEAL program pales in comparison to the FFELP. During the auction years, the annual HEAL volume never totaled more than $500 million dollars, borrowed by a few thousand students attending several hundred schools. HEAL providers are limited to a handful of lenders and just two servicers. In contrast, each year, the FFELP program makes more than $20 billion in loans to approximately 4 million borrowers enrolled at 6,000 institutions.

Congressional Budget Office analysis. A Congressional Budget Office (CBO) research effort may identify possible auction models for examination by the study group. The purpose of the CBO research paper, according to the request made by Senate Budget Committee Pete Domenici (R-NM), is to identify the pros and cons of at least three basic market mechanisms, of which at least one is expected to be an auction. The CBO paper will not recommend a particular form of auction or other mechanism.

FFELP Auction Options

Rights auctions. Industry analysts have offered numerous possibilities that reflect differing views of how the auction could or should alter the structure of the student loan programs. One of the most commonly cited models is known as a "rights" auction. Just how would a FFELP rights auction work? Stated most simply, under a rights auction, bidders would compete for the right to make loans on the basis of criteria specified by the auction authority, presumably the Department of Education. Rights allocation criteria could include the cost of loans to borrowers, the cost to the taxpayer, other criteria, or a combination of criteria. Bidders, for example, could be invited to bid on the right or rights to make a specified amount of loans to a particular group of borrowers during a designated time frame at a pre-determined price.

A key issue in a rights auction is how to establish a system that guarantees ready access to loan funds by borrowers, regardless of the type of institution they attend or where they reside, and, at the same time, lower the subsidy cost to taxpayers and preserve service quality. As the questions in the accompanying box indicate, fashioning an auction mechanism to achieve this goal will not be easy. Some winning bidders, for example, may attempt to maximize loan portfolio yields by targeting their loan allocation to low-default, four-year institutions and graduate schools. Other lenders may desire to limit lending to a particular state or geographic area, making the goal of universal availability of loans more difficult to achieve. A rights auction may take one of many forms. The potential features of rights auctions are explored in greater detail later in this paper.

Key Questions about Rights Auctions

Would a sufficient number of lenders be willing to supply loans to high-default schools?

Would a rights auction provide sufficient incentive to loan providers to improve or even maintain service quality?

Would smaller loan providers be able to participate effectively, given the increased uncertainties inherent in the rights auction model?

If the auction process radically reduces the number of loan providers to just a few big lenders, would these be able to originate loans anywhere in the U.S.?

Would the imposition of new requirements on loan providers increase the complexity of the program or create new integrity issues?

What is the long-term impact on borrowers and their ability and willingness to repay their loans?

Loan auctions. Instead of selling loan origination rights, the federal government could auction existing portfolios of loans. This option is often identified as a mechanism to mesh the Federal Direct Loan Program (FDLP) with the FFELP. Under direct lending, the Department of Education is the lender and holder of loans. Under a loan auction, the government could sell these loans to lenders, secondary markets, or other private entities after the loans are made.

Some analysts suggest that FFELP loans could be originated by a single entity—presumably the Department of Education—and then could be auctioned to the highest bidder or bidders, which would then be responsible for servicing the loans and bearing default costs. Would-be purchasers would factor the future cost of funds, servicing expenses, and default losses into their bids. Others speculate that the federal government could bundle packages of loans into securities and auction the securities. All administrative aspects of the loans under such an auction would be determined in advance by the Department of Education. Any winning bidder would, in essence, be a passive investor in the loans.

In addition to shifting the delivery process to a single originator—presumably a government contractor—a loan auction could result in basic shifts in how student loans are serviced. Some industry observers believe an auction would result in lower quality servicing at a time when borrower satisfaction with current servicing arrangements is at an all-time high.

A final consideration relates to the impact on the cost of the loan programs to the federal government. There is no guarantee that a loan auction would reduce federal costs. Arguably, the federal government could elect to keep the loans on the government's books as federal assets if the bidding process did not produce an acceptable price, but only if Washington is willing to fund the student loan portfolio through the end of repayment. Under the current guaranteed loan program, loan providers value the development of relationships with borrowers. In many instances, these relationships serve as the foundation for the marketing of additional services. The advantages of the current program would change in a loan auction.

Policy analysts have suggested a variety of loan auction models. Key aspects of selling existing loan portfolios are discussed in the section that begins on page 18.

Key Questions about Loan Auctions

Would loans sold by the government carry a federal guarantee against default?

Who would be responsible for providing default prevention activities?

Would the auction terms stipulate repayment terms and conditions, such as length of repayment period and borrower benefits?

How would a loan auction affect service quality and innovation?

What would happen if the government failed to receive enough acceptable bids?

Features of Rights Auctions

As noted above, multiple variations on the basic rights auction model are possible. This section briefly discusses 10 possible features of a student loan rights auction and their potential impact on the student loan delivery system. The list is not a comprehensive one but does cover issues that are central to the implementation of an auction program and the management of the risks that are inherent in using a bidding process to allocate loan origination rights.

1) **The nature of the rights sold.** The right to make student loans could be auctioned in dozens of different ways. Options include:

   - Rights to make loans to any eligible borrower.
   - Rights to make loans based on the type of borrower (student vs. parent, undergraduate vs. graduate student).
   - Rights to make loans based on presumed loan quality, as reflected in institutional cohort default rates or average borrowing levels for students attending the institution.
   - Rights to make loans based on the type of institution the borrower attends (community college, proprietary school, four-year colleges, research universities, graduate schools).
   - Rights to make loans in specific geographic areas, such as states or regions.

Rights could be tied to the location of the borrower's school or the borrower's state of residence or could be based on the risk profile posed by various categories of loans, such as those deemed highly vulnerable to default.

Some argue that allocating loan-origination rights on a regional or state basis could help rationalize the process for ensuring nationwide access. The winning lender or lenders for a given area would have to make loans to all comers, regardless of the type of institution attended by the borrowers. Nationwide loan providers are likely to oppose this approach.

Based on the experience of the HEAL auction program, local or regional lenders and secondary markets, particularly those with tax-advantaged sources of capital, can be expected to bid aggressively to claim their territories and thus assure future business. Aggressive bidding that results in widely different federal costs on a region-by-region or school-by-school basis would cause dissension among schools. Members of Congress are not likely to approve an auction system that would result in higher subsidy rates for some states than for others.

As noted above, bidders could be invited to bid on different portfolios, based on loan quality. This could be achieved by setting different subsidy rates for different levels of loan quality. In one model, participants would submit bids for one or more of several tiers of loan quality—for example, schools with default rates of less than 5 percent, schools with default rates of 5 to 10 percent, schools with default rates of 10 to 15 percent, and schools with rates of 15 percent or higher. Schools with persistently high default rates (25 percent or more) would be forced to leave the program. Guarantors and other designated lenders of last resort would be called upon to make loans to students in default categories that do not attract bidders. In the loan auction model, an appropriate role for the Department of Education would be to serve as the lender of last resort.

Finally, bidders could be granted the right to make loans only in a particular year or to make all of the loans issued to a particular borrower. The first approach is simple but could prove disruptive to borrowers and financial aid administrators who find themselves dealing with a new lender every year. A revolving door of lenders will confuse borrowers and could trigger a continuous stream of processing upheavals in the financial aid office. Then, too, this type of rights auction could disrupt the ongoing implementation of the Master Promissory Note (MPN), which was developed to reduce paperwork hassles and encourage serial borrowing. The second approach—granting serial borrowing rights—could ease the loan process for borrowers but could simultaneously restrict their ability to choose their lenders.

2) **Bid pricing terms.** Bids in a student loan auction need not be made exclusively on the basis of bidder payments to or from the government. Participants could submit bids based on their minimum lender yields or on a combination of terms, including the interest rates paid by borrowers, up-front fees, and repayment terms. This method is used by the HEAL program. Basing bids on repayment terms would provide a method for granting a different interest subsidy rate for loans that are repaid under an income contingent repayment plan. In addition, lenders would have an incentive to develop innovative repayment strategies and offer interest rate discounts or other rewards for on-time payments.

Although the specification of bid-pricing terms provides an opportunity to promote innovation, incorporating unfamiliar or complicated terms could discourage smaller lenders from participating in the program. A highly complex mechanism may require an equally complex evaluation method and would likely engender protests by losing bidders.

3) **The frequency of the auctions.** Many presume student loan auctions would be held annually. However, there is no inherent reason that would require yearly sales. Auctions could be held as frequently or infrequently as necessary to assure the availability of loans to borrowers and their families. Yet, there are pros and cons to every basic approach to the timing of rights auctions. For example, a major risk of annual auctions is the potential lack of continuity, not only for schools but also for lenders. Borrowers and schools do not want to deal with an ever-changing cast of loan providers, as could be the case under an annual auction process.

Some contend that holding auctions every five years rather than on an annual basis could help meet two key goals: continuity of service and continued investment in product delivery. A longer-term auction process, it is argued, would help satisfy serial borrowing needs of borrowers and schools; the latter do not want to constantly change their systems for receiving loan funds. Lenders and other players are also more likely to stay in the game and invest in service enhancements. Lenders are unlikely to improve service if they perceive an unacceptable risk of being eliminated in the next auction. However, long-term auctions could introduce an unacceptable level of interest rate risk, depending on the type of rate index used to bid the subsidy.

Others believe that infrequent auctions would simply result in the permanent elimination of those loan providers that lose out in the initial auctions. New sources of capital or loan providers offering innovative new loan delivery mechanisms could be frozen out of the process. Furthermore, the federal government would not benefit from administrative cost reductions that could be achieved through the adoption of new technologies that would, in turn, foster more competitive bidding.

4) **The volume of loan rights sold.** A key question posed by the loan auction model is how much student loan volume would be scheduled for sale. Some suggest that the government could sell an entire year's volume in one session. Others contend that the loan rights allocations should be distributed over a series of auctions, permitting adjustments to be made on an on-going basis.

One potential complication to a multi-stage auction process is assuring that borrowers are able to receive all of their loans from a single loan provider. Serial borrowing is a goal shared throughout the student loan community. Thus, most models of a rights auction stipulate that, once a lender wins the right to make loans to a borrower, the lender would gain the right to make any and all subsequent loans to the borrower. Unfortunately, including serial loans with the right to make the initial loan makes it more difficult for lenders to price their bids and for the government to evaluate the offers.

Some suggest that the auctions allocate only one-third to one-quarter of each year's anticipated new volume—for example, the portion of new loan volume that goes to first-time borrowers. The winning bidders would also gain the right to make subsequent loans to those borrowers. This approach could help minimize disruptions in loan providers and help preserve serial borrowing but, again, would significantly complicate the auction process. Even so, depending on the geographic distribution of winning bids, a staggered-volume auction could prove problematic in ensuring the availability of funds to every borrower in every state.

Most models of rights auctions envision Washington selling more loan capacity rights than students and parents would actually need. This could help ensure sufficient participation and competition by lenders. For example, if the program needs $30 billion in annual loan capacity, the government could accept bids to cover $60 to $90 billion. Lenders would then compete with each other in the market, but their individual loan volumes could not exceed their auction quotas.

The auctioning of rights in excess of envisioned demand, while helping to assure borrower access to loans, could create additional program complications in the form of compensation to lenders for unused auction rights. Related to this potential problem is the question of whether successful bidders would be authorized to sell rights to other holders, creating, in essence, a secondary market in student loan rights.

5) **Limits on individual bids.** A major challenge of the auction concept is how to maintain a fair and open bidding process. Among the key issues are whether a single capital provider should be allowed to successfully bid the entire volume of loans auctioned each year or whether a maximum limit should be placed on the volume won by a single entity.

Participants in the auction could be limited to bids that are a given percentage over their current market share; for example, a lender with 8 percent of the market could bid for no more than 10 percent of new loan volume in a specified time frame. Alternatively, there could be overall limits on market share bids or allocations; that is, no one bidder could receive more than a set percentage of the volume. In the latter case, the auction process could favor existing loan providers, effectively frustrating the goal of some to attract new capital providers to the student loan market.

Another concern relates to differences in the cost of funds currently enjoyed by some loan providers. An auction system that allocates market share strictly on the basis of price will favor the players that enjoy the lowest cost of funds—that is, the largest banks and tax-advantaged players, such as tax-exempt secondary markets. Because the market is already concentrated among a small number of large banks, several auction rounds could effectively eliminate all but a few lenders. This approach, thus, would limit school choice.

One solution to this problem is to set aside a small volume of loan rights to financial institutions below a specified size. This so-called "small lender set-aside" would assure that at least some smaller lenders would remain in the student loan program. Some have criticized this suggestion, noting that it would essentially guarantee that the federal government would pay higher subsidies than necessary, at least to some lenders.

6) **Penalties.** A key issue in a rights auction is how to police the subsequent actions of lenders to assure that rights are awarded according to any stipulated terms and conditions. For example, in a general auction of loan rights, lenders may be required to make loans to any eligible borrower. If a lender chooses to maximize the return on the student loan portfolio by marketing only to high-cost, low-default rate schools, would that lender be in violation of the regulations governing the auction?

To address the access issue and similar problems, the auction system could include penalties for lenders that do not make required use of their market allocation or otherwise violate the terms of their awards. For example, if a lender receives a $500 million loan rights allocation but uses that allocation to make only $200 million in loans, the lender's rate subsidy could be reduced. This approach would help prevent the supply of available loans from falling short of demand. Conversely, penalties could be imposed on lenders that exceed their quotas.

It is highly likely that the imposition of penalties on lenders would discourage some potential loan providers from participating in the bid process. Similarly, the concept of policing lender behavior raises serious questions about the extent of additional regulatory burdens and reporting requirements that would be placed on lenders.

7) **Stipulations for loan terms and servicing standards.** An auction that focuses strictly on price could sacrifice future product and service enhancements and, at same time, erode current quality standards. An approach that considers servicing standards would certainly complicate the auction process, and such restrictions could be designed to eliminate certain potential bidders. Small lenders, which can't afford the cost of submitting complicated bids, may withdraw.

   One possible solution to this problem is to pre-qualify bidders to assure that certain servicing standards will be met. This idea could help assure initial quality but would provide no guarantee that quality would be maintained over the long run. Similarly, issues are raised regarding that sale of loans to other holders. Would the Department of Education also have to qualify these third parties to hold loans?

8) **Restrictions on loan servicing arrangements.** To minimize disruptions to borrowers and schools, auction advocates have suggested several ways to maintain continuity of loan servicing. For example, winning bidders could be required to use loan servicers selected by schools or borrowers. This would address serial borrowing needs but may not be viewed as practical from the lenders' point of view. Some lenders could be barred from servicing their loans in-house, while others could face limited options for selling loans to secondary markets. Moreover, allowing schools to stipulate servicers would put lenders at an inherent disadvantage in negotiating servicing contracts.

9) **Restrictions on bidders.** Allocating a major share of loan origination rights to a lender that ultimately lacked the capacity to deliver could prove catastrophic for schools and students who must have the loan funds at enrollment time. To address this problem, bidders could be required to demonstrate they have the financial resources and delivery system to supply their allocated loan volume. This is a standard practice in many rights auctions, however, it would further complicate the evaluation process, and bidding standards could be manipulated to favor existing program participants over potential new capital providers. This approach would most likely impose new federal oversight and reporting requirements.

10) **The bidding process.** Loan rights could be awarded after a single round of sealed bids or a multi-stage bidding process. Several rounds of bidding could establish the lowest price needed to keep a sufficient number of lenders in the program to meet borrowers' needs. Elimination-round bidding, however, would be complicated and time consuming and would probably favor bigger players.

Features of a Loan Auction

By all accounts, an auction of loans already made by the Department of Education would be, from the standpoint of auction administration, simpler than an auction of the right to make loans. This section briefly discusses possible features of a loan auction and the potential impact on how students and schools participate in the student loan programs. Like the discussion of rights auctions above, this list is not comprehensive, but it does address the central issues.

1) **How loans would be sold.** In a loan auction, the government may sell loans it holds directly, or it may bundle portfolios of loans and auction them as asset-backed securities. This latter approach would be similar to a financing mechanism now widely used in the guaranteed student loan program.

   If loans are sold directly, the price received on the loans will depend in large measure on the types of loans sold. For this reason, the packaging of loans for sale would be a critical step in managing loan sales. Factors such as the probability of default and the average account balance would result in a higher or lower bid price of loans. These factors would also be taken into account by bidders if loans were sold via asset-backed securities.

2) **Guarantee vs. no guarantee.** Loans sold by the government may or may not carry a guarantee against the borrower's default, disability, or death. If a guarantee is offered, a key decision will be whether that guarantee would be issued by the Department of Education itself (as it did under the now-defunct Federal Insured Student Loan Program) or by an existing FFELP guarantor.

   The price received by the government for auctioned loans would be much higher in the case of loans subject to a guarantee than in the case of loans not subject to a guarantee. If the borrower defaulted, the loss would fall to the holder instead of a guarantor or the federal government.

3) **When loans would be sold.** To assure that all loans made to an individual borrower are held by a single holder or serviced as a single account, loans are unlikely to be sold until the borrower has completed his or her educational career. This means that the Department of Education would hold very large volumes of student loans during the in-school period. The Department would also have to service these loans, ostensibly in much the same way as Federal Direct Loans are serviced.

4) **Pricing.** Bidding could be based on the characteristics of loans included in the lot offered for sale. Because the bids will differ significantly based on a portfolio's loan mix, some sectors of higher education could pressure the Department of Education to make sure that all lots offered for sale are representative of the entire national portfolio of loans.

5) **Frequency of auctions.** The timing of auctions will be set in large measure by the Department's determination of the impact on the prices received for lots of loans offered. Frequent—and thus smallXloan offerings could discourage some potential bidders. In contrast, infrequent auctions could also discourage widespread participation. Auctions would be held periodically, with at least one auction per year, depending on the volume of loans available for sale. Because it is unlikely that loans would be sold while borrowers are in school, initial sales of loans may involve portfolios of loans to students who attended shorter-term courses of study. These initial loan sales would not be typical of subsequent sales, which would include a larger volume of loans issued to students with multiple years of postsecondary education.

6) **Qualification of bidders.** If loans are sold as asset-backed securities or are subject to life-of-the-loan servicing arrangements set by the Department of Education, bidders would not have to possess any special expertise in managing student loans. If successful bidders are granted the right to service their purchased loan portfolios, the Department would be likely to pre-qualify bidders to assure that loans would be serviced in the best interests of borrowers. Such pre-qualification would be especially important if loans are sold without federally supported guarantees or insurance.

7) **Impact on customer service.** A major concern relates to the quality of customer service as experienced by students and schools. It is obviously impossible to know just how customer service would change, but current incentives on the part of guaranteed student loan providers to provide quality service to students and schools would be decreased in a loan auction. Bidding in such an auction is likely to take place years after the promissory notes are signed, rendering excellence in service as largely irrelevant to securing loan volume. Moreover, this approach is not likely to provide the incentives needed to ensure quality servicing of loans in repayment. If this analysis is correct, service quality will deteriorate. This is not just an issue of convenience for borrowers and schools. Erosion of service quality means less effective communication with borrowers and thus increased chance of repayment problems. The key to effective default prevention is staying in touch with borrowers.

8) **Auction of the existing Federal Direct Loan portfolio.** Some advocates of student loan auctions have suggested that an auction would provide an opportunity to "merge" the current FFELP and the Federal Direct Loan Program into a single program. If such an approach were taken, a loan auction may include sale of the entire outstanding portfolio of the Federal Direct Loan Program. This portfolio currently consists of more than $45 billion in outstanding loans, a growing percentage of which are in repayment.

Long-Term Implications of a Student Loan Auction

In theory, an auction process could help lower the cost of federal education loans over the short term. Over time, however, an auction approach is likely to reduce the number of market participants, since losing bidders are unlikely to remain in the student loan business. Based on the HEAL experience, an auction process is unlikely to meet the needs of schools.

A decline in the number of market players could eventually reduce the competitiveness of the auction. Fewer players mean bigger players, raising the costs and stakes of trying to enter or re-enter the market. As the number of bidders dwindles, so does the pressure to hold the line on costs and lender-yield requirements. The remaining bidders would have little incentive to improve service quality or invest in new technologies. Without assurances that they will "win" an auction, lenders will have no incentive to make long-term investments in loan origination or servicing systems. Lenders simply cannot assume that they would fully recoup the cost of such investments. Eventually, borrowers could pay higher rates and taxpayers could fund bigger subsidies for stagnating service levels.

Moreover, auctions will create disruptions in the student loan delivery system. Losing bidders could be abruptly forced out of the program. Such dislocations force borrowers and schools to locate new sources of funds and split borrowers' loan portfolios among multiple loan holders and servicers. Such changes would be the result of shifting lender relationships rather than innovation. Although measures could be implemented to increase the number of bidders or enhance loan terms, such steps tend to increase program costs and complexity and thus undercut the benefits of an auction pricing system.

Is the Current Federal Family Education Loan Program "Market-Based"?

Most advocates of student loan auctions contend that the current guaranteed loan program is not "market-based." They argue that only an auction would establish a truly fair price for the government to pay as a means of inducing lenders to make loans. Critics suggest that the current approach, which sets returns to lenders under a formula specified in the Higher Education Act, overpays lenders and thus is not "market-based."

To determine whether the FFELP is market-based, it is useful to look at the two basic ways lenders compete in the student loan marketplace today: price and service. By most accounts, lender competition based on service became fierce in the late 1980s, well before the enactment of the Federal Direct Loan Program in 1993. During this period, FFELP loan providers developed and implemented continuous improvements in loan delivery systems and servicing standards, notwithstanding the absence of any federal requirement to do so. For example, millions of dollars have been invested in sophisticated automated account inquiry services borrowers can access via telephone or the Internet. The Web sites of lenders, loan servicers and guarantors offer dozens of calculators and other interactive counseling resources. Over the last five years, lenders intensified their efforts to win customers by increasing the focus on price. Today, competition based on the cost of loans to borrowers is virtually universal. Clearly, students and parent borrowers are the primary beneficiaries of these free-market initiatives, and a recent government survey shows that the guaranteed loan program is enjoying strong gains in customer satisfaction among schools and borrowers.[8]

The competition in the FFELP offers a sharp contrast to the competition-attrition risk posed by virtually every proposed auction model. Over the long-term, it is virtually certain that auctions will ultimately reduce price competition among loan providers. Similarly, if use of an auction mechanism works as assumed by many of its advocates, government payments to lenders could be substantially reduced. Because an auction will diminish the competitive necessity of appealing to borrowers and schools on the basis of service, investments in customer service are likely to decline. Borrowers will face lower standards of service and any incentive to invest in new technologies will be eliminated.

Conclusion: Auctions May *Not* Be in the Best Interest of Students and Schools

Most discussions of student loan auctions assume that the federal government, probably the U.S. Department of Education, would auction the right to make student loans or loans already made by the federal government. In both cases, a new intermediary—the auctioneer—is placed between loan providers and borrowers.

This shifting dynamic will dilute market forces at work in the program. Under an auction model, competition on service would be sidelined entirely, and competition on price would be reduced, because there would be fewer players.

Ironically, another implication of an auction could be a dramatic increase in the federal government's role in the student loan delivery system. For an auction to work properly, bidders will have to be pre-qualified, and complicated rules relating to evaluating bids will have to be developed. Under a rights auction model, the Department of Education would face the task of determining whether to establish a secondary market in auction rights and how such a market would be regulated. Moreover, federal employees would have to police lenders to confirm they were not "skimming" the lowest risk borrowers or otherwise failing to serve all parts of the student loan market.

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[8] "Direct Loan Program Administration, 1993-1998," Macro International, under contract to the U.S. Department of Education.

In general, the myriad questions voiced regarding the structure and outcomes of student loan auctions focus on how to protect the interests of borrowers and taxpayers, while fostering competition. Policymakers can choose among dozens of alternative auction concepts for structuring the bidding process, including models designed to satisfy school concerns about retaining lender choice. Still, in many instances, addressing auction implementation issues would require the development of special rules and procedures or the creation of a management/oversight function within the Department of Education. As policymakers and Congress consider the issues, they should ask whether the negatives associated with an auction--increased complexity, abrupt changes in loan providers, a heavier regulatory burden, and eventual deterioration in service levels--outweigh the benefits.

Thus, any serious consideration of "market-based mechanisms" must start with a disciplined examination of the policy goals that underpin the federal student loan programs. The study group should not only evaluate new market-mechanisms against these objectives, but should also assess the current guaranteed loan program's track record in achieving national policy goals. This discovery process might well demonstrate that more could be lost than gained by adopting an auction system that radically alters the diverse incentive structure that currently drives FFELP loan providers to serve all eligible borrowers at ever-increasing levels of service and price benefits.

Questions about Auctions

The short overview of auctions presented in this paper does not begin to exhaust the questions the market mechanisms study must address. The following are some of the questions identified to date for the study group to consider:

Fundamental questions

Would borrower access to student loans be affected by an auction?

Would borrowers pay more, less, or the same for loans?

Would modernization of the student aid delivery system be supported or undermined?

Questions relating to the role of institutions

Would the current role of schools in screening loan providers be changed? If so, how?

Would a school lose the ability to work with a preferred loan provider?

Would loan providers' attention to the needs of schools be diminished?

Could an auction indirectly lead to lower servicing quality and higher institutional default rates?

Would institutions lose the ability to shop for lower rates for borrowers?

Questions relating to borrowers

Would borrowers lose their ability to choose a loan provider?

What options would the borrower have if the loan provider's service quality proved unsatisfactory?

Would an auction mechanism eliminate price discounting now in effect in the FFELP program?

Would an auction reduce borrower cost of loans?

Would an auction result in lower service quality by discouraging long-term investments in technology?

Would an auction discourage providers from being attentive to borrowers?

Would borrowers still be able to obtain all of their loans from a single loan provider or have all of their loans placed with a single loan servicer?

Questions for the federal government

What federal agency should run the auction?

Would the cost of the student loan program increase or decrease?

What new administrative personnel and structure would be necessary to run the auction and conduct related program oversight?

Would default risk be increased or decreased?

Would an auction necessitate an enhanced lender of last resort program?

Is the risk of a catastrophic program failure, such as the inability of the system to make loans in a timely fashion, increased?

Is the opportunity for fraud and abuse increased?

Questions for loan providers

Would loan providers be able to predict their volume of loan business from year to year?

What incentives would remain for high levels of customer service?

Would all current loan providers have a fair opportunity to participate in the auction process?

What new regulations and reporting requirements may be established?

How would unused auction rights be handled?

What options would the lender have with regard to servicing loans?

If non-quantitative criteria were included in the auction, would the auction administrator be able to evaluate such criteria?

Would entities with no prior experience in student loans be authorized to participate in the auction?

Would entities be authorized to sell unused rights or purchase rights from others?

Student Loan Auctions: Issues and Implications

A Brief History of Student Loan Interest Rates

Since the inception of the federal education loan program in 1965, Congress has orchestrated a series of changes in the interest rates charged to borrowers and the rates paid to lenders.

The original Government Student Loans (GSLs) carried a fixed, annual interest rate of 6 percent. Over the next 25 years, rates on GSLs, which were renamed Stafford loans in 1988, were adjusted periodically to reflect the upward trend in interest rates that accompanied the inflation of the 1970s and early 1980s. During the first 27 years of the program, Stafford loans continued to charge fixed rates. Although the repayment rates for loans issued to first-time borrowers eventually rose to 10 percent, some borrowers continued to pay rates of 6 or 7 percent, because federal rules capped their interest rates at the rate charged by their initial Stafford loans.

Variable rates were introduced for Supplemental Loans for Students (SLS loans) and PLUS loans in 1986, but Stafford rates remained fixed until the early 1990s. Over a two-year period, Congress approved three pieces of legislation that swiftly converted both new and existing Stafford loans to a variable-rate structure. The conversion began under the Higher Education Amendments of 1992 and continued under the Student Loan Reform Act of 1993 and the Higher Education Technical Amendments of 1993. These changes are summarized in the accompanying table.

The first variable-rate formula—the 91-day Treasury Bill rate plus 3.1 percentage points—applied only to "new" borrowers—those who had no outstanding Stafford balances on or after October 1, 1992. Beginning July 1, 1994, all new Stafford loans carried variable rates, adjusted each July, regardless of the student's status as an "old" or "new" borrower. To protect borrowers, these new Stafford variable rates were capped at 8.25 percent. The legislative changes also required lenders to convert a large number of fixed-rate Stafford loans to the variable rate. This action ensured that existing borrowers benefited from downward trends in interest rates. In addition, Congress established a two-tier rate system for Stafford loans issued on or after 1995. Under this system, borrowers who are paying back their loans pay higher interest rates than other borrowers. The borrowers who pay lower rates are as follows: borrowers still in school; borrowers who are in the six-month, post-school grace period; and borrowers in an authorized period of deferment.

In 1994, the Department of Education established its Federal Direct Consolidation loan as a variable-rate loan, even though the rules required a fixed rate for guaranteed Federal Consolidation loans. Emergency legislation enacted in November 1997 sought to alleviate a large backlog of unprocessed consolidation applications submitted to the Federal Direct Loan Program by allowing private lenders to consolidate direct loans. This legislation also established a variable rate for guaranteed Federal Consolidation loans, using the same formula in effect for direct loans.

Congress initially established the three-month Treasury bill rate as the index, or base rate, for Stafford and other variable-rate federal education loans. However, the 1993 Student Loan Reform Act scheduled a change in the formula to take effect July 1, 1998. This change called for switching the index to a loosely defined government debt instrument, which was generally interpreted to be 10-year Treasury bonds.

Federal education lenders and secondary markets soon realized that the 1998 formula was untenable. Lenders and loan holders finance their student loan portfolios with financial instruments tied to short-term interest rates. Tying the interest rate paid on these loans to a long-term interest index would increase financing risks and thus the cost of raising the money to fund new student loans. Many industry observers argued that virtually all private lenders would be forced to withdraw from the FFELP program within a few years, if the rate change scheduled for July 1, 1998, was allowed to take effect.

The controversy triggered a series of studies, and officials at the Department of Education and the Treasury Department eventually acknowledged that the new rate formula would not work. FFELP loans are the single largest source of financial aid to students, and many schools began to worry about the availability of Stafford loans for the 1998-99 academic year.

Correcting the problem proved difficult, because the school community and members of Congress wanted to preserve the interest rate reduction that would have gone into effect, at least for the 1998-99 year, under the 10-year T-bond formula. This rate reduction reflected an extreme flattening of the yield curve in late 1997 and early 1998. At that time, the yields on Treasury bonds hovered only 50 basis points above the three-month Treasury bill rate.

Working with members of the financial aid community, Congress eventually worked out a compromise plan that retained the three-month T-bill rate as the variable-rate index for Stafford and other federal education loans. The compromise, however, increased the complexity of the interest rate structure for education loans. The new legislation set different formulas for the rate paid by borrowers and the rate received by lenders.

The 1998 rate legislation also included provisions governing interest rates for federal consolidation loans. These provisions emphasized congressional intent to standardize key loan terms such as the maximum interest rate* for direct and guaranteed consolidation loans. The new law set the consolidation rate at the weighted-average interest rate for the loans being consolidated rounded up to the nearest one-eighth of 1 percent. This rate became effective for guaranteed consolidation loans on October 1, 1998, and for direct consolidation loans on February 1, 1999. The rate formulas enacted in 1998 are scheduled to remain in effect until 2003.

The accompanying table illustrates the effect of legislative changes and shifting interest rates on the cost of federal education loans over the past 34 years.

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* Under federal law, the rate formulas for guaranteed loans set the maximum rate lenders may charge. Lenders may charge lower rates.

GUARANTEED STUDENT LOAN INTEREST RATES FOR Stafford BORROWERS
1965-2003[1]

Effective Years	Rate Type	Interest Rate[2]		Formula
1965 - 1967	Fixed	6%		---
1968 - 1979	Fixed	7%		---
1980 - 1987	Fixed	9%		---
1988 - 1992	Fixed	8% - 10%		8% during the in-school, grace and deferment periods and the first four years of repayment; 10% during the remainder of the repayment period.
1992 - 1994	Variable	1992-93: 6.94% 1993-94: 6.22%		Adjusted annually on July 1, based on 91-day T-bill plus 3.1%, capped at 9%.
1994 - 1995	Variable	1994-95: 7.43%		Adjusted annually on July 1, based on 91-day T-bill plus 3.1%, capped at 8.25%.
		In-School Rate	**Repayment Rate**	
1995 - 1998	Variable	1995-96: 8.25% 1996-97: 7.66% 1997-98: 7.66%	1995-96: 8.25% 1996-97: 8.25% 1997-98: 8.25%	Adjusted annually on July 1, based on 91-day T-bill plus 2.5% during in-school, grace and deferment periods. Repayment rate is 91-day T-bill plus 3.1%. Capped at 8.25%
1998 - 2003	Variable	1998-99: 6.86% 1999-00: 6.32%	1998-99: 7.46% 1999-00: 6.92%	Adjusted annually on July 1, based on 91-day T-bill plus 1.7% during in-school, grace and deferment periods. Repayment rate is 91-day T-bill plus 2.3%. Capped at 8.25%.

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[1] Source: Higher Education Act of 1965, as amended, and U.S. Department of Education

[2] For borrowers with no previous federal student loans

APPENDIX IX

PUBLIC COMMENTS FROM THE CAREER COLLEGE ASSOCIATION

March 15, 2001

Mr. Gene Kuehneman
Senior Economist
U.S. General Accounting Office
441 G Street, NW
Room 5928
Washington, DC 20548

RE: Alternative Market Mechanisms for the Student Loan Program

Dear Mr. Kuehneman:

The Career College Association (CCA) is pleased to provide its comments on the draft report, *Alternative Market Mechanisms for the Student Loan Program*. The Career College Association is a voluntary trade association representing 850 schools, institutes, colleges, and universities which educate students for careers in a wide variety of fields including allied health, computer, hospitality, electrical and automotive, paralegal, and business office administration. Our members provide programs ranging from short-term diploma programs to associate, bachelors and masters degrees. The educational institutions in our sector educate almost 30% of the technically trained employees and serve a critical role in preparing our current and future work force.

GENERAL COMMENTS

CCA recognizes the delicate balance in establishing lender yields on student loans between guaranteeing access to sufficient loan capital for all students and keeping borrower costs and the Federal program costs at a minimum. This issue dominated the consideration of the Higher Education Amendments of 1998, and its budget implications placed significant constraints on the ability to expand borrower benefits such as reducing loan origination fees. CCA encourages the study group to identify ways to move this yield-setting process out of the political arena and allow market forces to regulate this balance.

Our major concern in examining the potential models put forth by the study group is ensuring that all students have uninterrupted access to student loan funds at the lowest possible costs of borrowing. In the current loan system, some loans are more profitable than others. Lenders have a market bias toward large, high-balance loans because the servicing costs are roughly equal to that of smaller balance loans in absolute terms, but represent a smaller percentage of the yield received on the loans, making the servicing costs per dollar lent significantly lower for high balance loans. Additionally, loans made to students in longer programs are more profitable because interest is allowed to be capitalized, and in addition the serialization of loans in a single account increases the borrower's account balance. Thus, a real potential for discrimination and denial of access to funds exists even in the current program for students who take out smaller loans for shorter academic programs. This potential could be amplified by a change to a market-based model.

Adequate safeguards to ensure uninterrupted access must be included in all models. It is also important to ensure that students who borrow smaller balances for shorter programs, many of whom are among the neediest students served by the programs, do not pay higher interest rates and loan fees than students borrowing larger amounts or who are enrolled in long-term programs. To achieve this result, uniform terms and conditions for all students must remain as a fundamental policy requirement for the student loan programs.

SPECIFIC COMMENTS

The following are some of our specific concerns over the various models under consideration:

Incremental adjustments model — CCA believes that there is a potential for a degradation of service quality as well as access problems under this model if it used to reduce lender yield too substantially. This incremental approach relies too much on Congress to establish acceptable yields. If yields are set too low, this could result in serious disruption in financing for students.

Loan origination rights model — This model also has potential for causing serious disruptions in access to loan originations. We also have concerns given the experience of the Health Education Assistance Loan (HEAL) program in using this type of model, and believe that it would make it difficult for students and families to predict their borrowing costs into the future.

Loan Sale — This model would mitigate much of the access risk by providing universal originations of loans, similar to the Direct Loan program. However, it is unclear how loans would be sold after origination, how the loans would be guaranteed, and what choice, if any, the borrower would have in deciding who purchased or serviced their loan. We also have concerns over the servicing quality of loans purchased by the lowest bidder.

Federal Funding — This model seems to have little potential effect on the delivery of student loans and is not truly a market-based mechanism. However, as in the first model, it has the potential for disruption in access if Congress uses lenders' reduced cost of funds to lower yields below what is acceptable to lenders.

Market-Set Rates — This model has the most potential for discriminatory effects and "redlining" implications. CCA does not support any model which would result in unequal borrower rates and benefits at differing institutions because it would disproportionately discriminate against the neediest students currently served by the programs. Such a model would likely result in lenders charging the neediest borrowers the highest rates for student loans. Any market-rate model should not allow for the differentiation of loan terms and conditions by borrower type, loan balance, or type of institution.

Income Contingent Repayment — This model also seems to have little potential effect on the delivery of student loans. CCA would be supportive of expanding the benefits of Income Contingent Repayment presently available only to Direct Loan borrowers to all borrowers to help them better manage their repayment obligations relative to their income.

Thank you for the opportunity to comment on the draft proposal.

Sincerely,

Nancy B. Broff
General Counsel

APPENDIX X

PUBLIC COMMENTS FROM CBA, NCHELP, AND SLSA

By E-Mail and Fax

March 19, 2001

Public Comments on MMSL Draft Report
c/o Mr. Gene Kuehneman, Senior Economist
US General Accounting Office
441 G Street, NW, Room 5928
Washington, DC 20548

Dear Mr. Kuehneman:

The undersigned welcome the opportunity to comment on the draft report entitled "Alternative Market Mechanisms for the Student Loan Program". We recognize that the draft report represents the results of a huge undertaking by the General Accounting Office and the Department of Education (as well as the other government agencies that participated in preparing the draft). Overall, the draft report presents a fair comparison of the proposals reviewed. Accordingly, our comments will be limited to a couple overarching observations, together with a handful of comments on statements in the body of the draft report which, in our view, are inaccurate or lack support.

As a general matter, we do not believe the draft gives sufficient credit to the success of the current Federal Family Education Loan Program (the "FFELP"). Since 1965, the FFELP has made higher education affordable for over 40 million Americans. Access to FFELP loans is universal. Similarly, we not believe the draft report recognizes the market features that are currently thriving in the FFELP. There currently is intense competition in the FFELP, with the result being not only lower interest costs to students, but first class service as well (competition in the area of service quality is a feature of the FFELP that would be absent in the case of many of the market mechanism models analyzed in the report). We know that it was decided that the Study Group's report would not contain specific recommendations on future courses of action. But let us say loud and clear, we do not believe the draft report's analysis on any of the models studied justifies dramatic changes to the current program.

We also believe, in general, that the report minimizes the transition costs to any new system. We believe that implementation of many of the models would create substantial disruption. This disruption would adversely affect schools and students as well as FFELP participants. A related concern is that under the various models change would be forced upon the FFELP community but not the Federal Direct Loan Program. It should be obvious that if one program were to undergo a dramatic overhaul, many schools would seek the stability of the alternative program not being changed. This would be unfair to those schools and students who participate in the FFELP, as well as to those involved in the delivery of FFELP loans.

A final comment relating to the Direct Loan Program deserves mention. As noted above, we do not believe the draft report adequately recognizes the success of the FFELP. The draft report, on the other hand, goes overboard in praise of the Direct Loan Program. We draw your attention in particular to the discussion on pages 22 and 23. The draft seems to give the Direct Loan Program credit for the substantial reduction in the default rate on student loans. This is disingenuous. The decline in the default rate in the FFELP, by far the largest student loan program, is the result of intense efforts by FFELP participants, actions by both the Congress and the Department of Education, and the strong economy. The draft report also mentions that the Direct Loan Program gives schools a customer service emphasis (implying that the FFELP does not). The draft fails to note that the Department's own surveys have consistently shown that customer satisfaction with the FFELP is higher than with the Direct Loan Program. We also take issue with statements that attribute budget savings to the Direct Loan Program. The Department's Inspector General has concluded that "if administrative and subsidy costs are added together, at any point in time FFELP or FDLP total costs may be greater given prevailing market conditions." U.S. Dep't of Education, Office of the Inspector General, *Study of Cost Issues: Federal Family Education Loan Program/Federal Direct Loan Program* (March 1999, p. 9).

As mentioned above, we are limiting our comments on the discussion sections of the draft report to those select areas where we believe the discussion is significantly off base. In Chapter 3 (Loan Origination Rights Auction), the draft states that auctions have the potential to reduce FFELP costs. See page 37 (and Table 10). We note that this is only true if there are substantial excess profits in the FFELP, a qualification that is acknowledged later. See page 38. We do not believe there are excess profits in the FFELP, and note that the return on assets on FFELP loans is lower than that for alternative loan products. The statement on page 38 that the rights auction conducted for the Health Education Assistance Loan Program created savings to the federal government is incorrect because the Federal government did not receive any proceeds from the auction and did not benefit from any interest reductions. Furthermore, the widespread dissatisfaction among schools with the HEAL auction program is not adequately discussed (it is only alluded to in a footnote on page 41). The draft report states that "[a]uctions could either reduce the quality of service or have no effect on it." See page 40 (and Table 10). This statement is based on the conclusion that "[a]uctions might shift the balance of competition toward price competition and away from service competition." We do not believe there is any question that service quality would deteriorate and believe the draft report should be more definitive on this point. Because all competitive energy would be focused on the auction, it is also likely that lenders would eliminate current borrower benefits, thus increasing borrower costs. We believe this should be mentioned in the analysis. Finally, we note that the draft report states that "some school representatives" stated that schools and students value the ability to deal with a single lender (which relationships would be jeopardized by an auction system). See page 44. We believe this opinion is common among schools.

With respect to Chapter 4 (Loan Sale), there is a statement that this model would entail adjustment burdens on lenders. The adjustment will adversely affect schools (particularly

FFELP schools) and borrowers as well. Also, both borrowers and schools would lose the ability to choose their lender. The draft report states that under the loan sale model there would be no need to pay the in-school interest subsidy. See page 46. We did not understand that under this model borrowers would be required to pay interest while they are in school. There also is a statement that under this model "borrower costs are unlikely to change much." See page 49 (and Table 11). For the same reason noted in the previous paragraph, it is likely that borrower costs would rise as lenders eliminate borrower benefits. Since service quality will also deteriorate, the statements on this point should be more definitive. See page 50 and Table 11.

With respect to Chapter 6 (Market-Set Rates), we believe the description of the proposal is in some respects inaccurate. For example, the draft states that under this model there would be no subsidies to the borrower other than the guaranty. There is no reason why the government could not continue to subsidize in-school interest. The report also states that lenders might reduce the quality of service or leave it unchanged. In our view, lenders likely would be incentivized to increase service quality, since service quality would remain a criterion on which schools and students choose their lenders. Finally, the report states that adjustment challenges would be greater under this model than under the others. We disagree. The adjustment required to implement the models discussed in Chapters 3, 4 and 5 would at least be as great, if not greater.

We appreciate the opportunity to provide comments on the draft report. We would be happy to elaborate on any of these comments if you so desire. Finally, we commend the valuable contributions of the public members of the Study Group. We believe the balance evidenced throughout the report reflects in many respects the thoughtful advice they provided.

Consumer Bankers Association (CBA)
National Council of Higher Education Loan Programs, Inc. (NCHELP)
Student Loan Servicing Alliance (SLSA)

Cc: Barbara Bovbjerg, GAO
Maureen McLaughlin, Department of Education

APPENDIX XI

PUBLIC COMMENTS FROM FINAID PAGE

Received by e-mail on March 7, 2001.

Dear Mr. Kuehneman,

I noticed in your draft report, Alternative Market Mechanisms for the Student Loan Program (http://www.gao.gov/mmsl/comments.htm), Appendix IV, page 93, that you wrote:

Analyses of possible repayment options, as well as contemporary repayment calculators that are provided to aid borrowers choices among various repayment plans, are typically described in total dollars rather than in terms of the net present value of those dollars. This can make ICR seem to be more expensive for borrowers than it really is. Some observers believe that this illusory high-interest cost of ICR has discouraged financial aid administrators from urging borrowers to consider choosing it.

The FinAid site provides a repayment calculator for the ICR program that does include net present value calculations. You can find the calculator at
http://www.finaid.org/calculators/icr.phtml
You will notice that it not only has more features than the ICR calculator available on the US Department of Education web site, but is also more accurate. I am not aware of any other repayment calculators for the ICR program. Approximately 150 people a week use our ICR calculator.

I am also writing to draw your attention to a report by Prof. Phil Schrag of Georgetown University Law School (schrag@law.georgetown.edu). His report analyzes the ICR program in depth, identifying several possible reasons why it is underutilized and giving suggestions for improving the program. I highly recommend reading his report.

Mark Kantrowitz
Publisher, FinAid and EduPASS
A FastWeb Student Resource Site

Mark Kantrowitz, Publisher FinAid!
FinAid Page, LLC The SmartStudent Guide to Financial Aid
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Pittsburgh, PA 15217 1-412-422-6189 (fax)
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APPENDIX XII

PUBLIC COMMENTS FROM NATIONAL STUDENT LOAN PROGRAM

nslp National Student Loan Program

March 14, 2001

Mr. Gene Kuehneman
Senior Economist
US General Accounting Office
441 G Street, NW, Room 5928
Washington, DC 20548

Dear Mr. Kuehneman:

This letter offers NSLP's comments on the draft report about how market mechanisms, or market forces, might be introduced to determine lender yield in the Federal Family Education Loan Program (FFELP).

NSLP is a private nonprofit corporation serving as a federally designated guaranty agency in FFELP. Our mission is to bring education within reach for students all across America. Because of this mission, we are uncomfortable with the concept of introducing market forces or, more accurately, an increased reliance on market forces into FFELP. We are concerned that such an act would be inconsistent with the program's historic mission of making low cost loans available to all students. We believe it could destabilize FFELP's lender pool. We are also troubled about its potential to undermine the advantages that lender competition brings to students and institutions.

FFELP was created in the 1960s as a countermeasure to the market forces that naturally affect student loans. These forces – which include default risk, liquidity issues and the relatively low rate of return offered by student loans – made it impractical for private lenders to offer needy college students loans at reasonable rates of interest. Federal intervention was necessary to make widespread access to educational credit possible by overcoming these market forces.

FFELP now fulfills more than 60% of the nation's educational borrowing needs. The availability of FFELP loans is critical to millions of students who must borrow to enroll in postsecondary institutions. Some options identified in the draft report could again make it impractical for private lenders to originate low-cost loans for needy students attending less-prestigious postsecondary institutions. These options are incompatible with FFELP's historic mission. They are also contradictory to growing concerns about the need to increase postsecondary access for students from low-income families.

Some options identified in the draft report could also limit lender participation and lead lenders to drop into and out of FFELP on a periodic basis. This would reduce the ability of students, families and postsecondary institutions to select their lender partners, then to go on borrowing from those partners. As a result, we believe that:

- students would become confused because they would be forced to work with multiple lenders;
- the quality of service to individual and institutional customers would erode as lenders, unsure about the opportunity for long-term FFELP participation, would balk at investing in the human and system resources that serve students, parents and schools; and

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Mr. Gene Kuehneman
Page 2
March 14, 2001

- administrative costs and burdens would increase for postsecondary institutions, as they would be forced to reprogram their student aid systems to keep them compatible with frequent changes in lenders and lender delivery systems.

Some options identified in the draft report would also stifle competition among FFELP lenders. Such competition is the most positive and powerful of all the market forces currently at play in FFELP. Despite the impact of negative market forces such as those described above, it causes lenders to

- provide FFELP loans to all eligible students at all eligible postsecondary institutions;
- offer reduced interest rates and fees to many student and parent borrowers; and
- give high quality service to borrowers and postsecondary institutions.

NSLP favors changes that would improve FFELP, but we do not believe it is necessary for FFELP to undergo a massive overhaul such as that which would be necessary to implement options identified in the draft report. It is our hope that the government will refrain from introducing any market forces that would be inconsistent with FFELP's historic mission, weaken FFELP's lender pool, or undercut the benefits of lender competition for FFELP borrowers and institutions.

Thank you for the opportunity to comment on the draft report. Please contact me at 402-479-6812 or tomm@nslp.org if you have any questions about this letter.

Sincerely,

Tom Melecki, Ph.D.
Vice President, Policy Research & Planning

APPENDIX XIII

PUBLIC COMMENTS FROM OKLAHOMA LENDER ADVISORY COUNCIL

Received by e-mail on March 6, 2001.

Public Comments on MMSL Draft Report
c/o Mr. Gene Kuehneman, Senior Economist
US General Accounting Office
441 G Street, NW, Room 5928
Washington, DC 20548

The Oklahoma Lender Advisory Council, Inc. (OLAC, Inc.), consisting of lenders, servicers and secondary markets participating in the Oklahoma lending community, is submitting the following comments in response to the Draft Report on Alternative Market Mechanisms for the Student Loan Program.

According to the draft overview, the central reason for the study, mandated by Congress, was to determine ways of gathering more credible information on which to base lender yield. Section 801 of the 1998 Amendments to the Higher Education Act (HEA) mandated the study of alternative market mechanisms.

Surprisingly, none of the models described in the alternative market mechanism report seriously address ways of gathering more credible information on which to base lender yield. Instead, models described appear to have great potential for causing interruption to the delivery of loan funds and services to students by virtue of the degree of radical change required by the respective models.

The current model for delivery of loan funds to students and the objectives and integrity of the FFEL program are functional and intact; therefore why change them? Among the federal Title IV programs, citizens clearly depend most heavily on the FFEL program to fund post-secondary educational goals. A close look shows that only a small percentage of the cost of the program is realized as revenue for the lenders; the vast majority of funding that runs this program is reinvested into the program. To de-stabilize the program in any way, particularly in the ways described by at least four of the market mechanism models in this draft report, would be to risk access to higher education for many and to defer or deny educational goal attainment for many others currently relying on this program.

Model 1, Adjustments to the Current System, appears to be least problematic of the five. This model protects the current competition-based model, which we believe is in the best interest of the borrower. This model also offers the least disruption to the delivery of loan funds and services to student consumers.

Model 2, Loan Origination Rights Auction, could create some of the same problems that were created during the last stages of the now defunct HEAL program. Students could not rely on continuity of service, lender relationship or even funding availability. Use of loan consolidation to solve the problem of multiple loans with multiple lenders, is not in the best interest of all students. Last, schools are put in the uncomfortable position of soliciting lenders.

Model 3, Loan Sale, could deter lender participation, reduce the quality of customer service to students, and increase liability for the federal government and thus for the taxpayer. Timely fund appropriation for this popular program would also become a new issue.

Model 4, Federal Funding, creates similar concerns as those stated for the Loan Sale Model. In addition, we believe it would also create chaos, uncertainty and student access problems.

Model 5, Market-set Rate, creates a very serious concern for student access, would require a lender of last resort, puts lenders in an adversarial position with their customers, could cause serious problems for schools where loans were not readily available for their students and creates disruption.

OLAC, Inc. does not want the perceived need for a new way of determining lender yield to jeopardize a strong viable program designed to facilitate the education of our citizens. We believe models 2 through 5 would indeed jeopardize FFELP whereas Model 1 appears to be least problematic.

The current lender yield formula, based on the Commercial Paper (CP) index, is working adequately; therefore, why change it? No market-based mechanism is perfect nor will any formula or financial instrument fulfill all of the important financial objectives of the program forever. However, recently, Congress helped encourage continued lender participation with its legislation of the current (CP index) mechanism. OLAC, Inc. would like to see the current formula remain in place as long as feasible.

Sincerely,

Oklahoma Lender Advisory Council, Inc.

Oklahoma Lender Advisory Council, Inc. Members

Arvest Bank
BancFirst
Bank of Oklahoma
Bank One Education Finance Group
Chase/Education First Marketing

Citibank Student Loan Corporation
Citizens Bank of Edmond
Educational Funding Services, Inc.
Key Bank, USA
Lincoln National Bank
Local Oklahoma Bank
NHELP Marketing
Oklahoma Guaranteed Student Loan Program
Oklahoma Student Loan Servicing
Rockwell Bank
Sallie Mae
Stillwater National Bank
Tinker Federal Credit Union
UMB Bank

APPENDIX XIV

PUBLIC COMMENTS FROM PHILIP SCHRAG

Georgetown University Law Center

Philip G. Schrag
Professor of Law

March 7, 2001

Mr. Gene Kuehneman, Senior Economist
US General Accounting Office
441 G Street NW
Room 5928
Washington, DC 20548

Dear Mr. Kuehneman

Although consideration of income-contingent repayment is only a small part of the work of the Market Mechanisms study, your Report does offer an opportunity to highlight the problems with the current ICR system and to recommend improvements. Indeed, the draft report hints at one such possible improvement on page 93, when it implies that the government's comparisons among repayment plans should be stated in terms of net present value rather than current dollars, and that current dollar comparisons may mislead financial aid administrators and cause them to discourage the use of ICR even for graduates with very high educational debt and very low income:

> Analyses of possible repayment options, as well as contemporary repayment calculators that are provided to aid borrowers' choices among various repayment plans, are typically described in total dollars rather than in terms of the net present value of those dollars. This can make ICR seem to be more expensive for borrowers than it really is. Some observers believe that this illusory high-interest cost of ICR has discouraged financial aid administrators from urging borrowers to consider choosing it.

(Actually, an important interactive repayment calculator, which I helped to develop and which is maintained by FinAid, does offer net present value comparisons. The URL is www.finaid.org/calculators/icr.phtml).

The government's failure to make net present value comparisons is, however, only a relatively minor problem with the current ICR program, which has mostly failed to meet the Congressional objective of enabling idealistic students to live lives consistent with their desire to work in low-paying public service jobs. The main problem with the program is that few graduating students, even those with very high debts and very low incomes, give even a passing thought to a repayment plan with a 25-year payback

600 New Jersey Avenue NW · Washington DC [illegible]
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period. And although the law required the Department of Education to forgive ICR loans after a maximum period of 25 years, the Department treated the maximum as the minimum and has never seriously considered using its existing statutory authority to offer forgiveness after a shorter period, such as fifteen years. Unofficial estimates that I have received from the Department suggest that the additional subsidy cost of even a drastic reduction in the period before forgiveness would be quite small.

The draft report assumes that the 25-year term is immutable. E.g., at page 73, it defines future subsidies under a reformed lending scheme in terms of "loan balances forgiven after 25 years." Instead, it should mention that the Department (or Congress) might consider a shorter term before forgiveness as a way making the ICR program meet its original objectives.

Another serious problem is that the current ICR plan imposes a huge penalty on marriage, by treating all spousal income as available to a borrower, even when it is not. In addition, while the Department of Education made serious efforts to educate the financial aid community about ICR when the plan was first established, its follow-up efforts have been poor.

These and related points are more thoroughly asserted and documented in the enclosed draft manuscript for my forthcoming book, *Repay as You Earn*, which will be published in December or January. An article version of this work, *The Federal Income-contingent Repayment Option for Law Student Loans*, will be published this summer by the Hofstra Law Review.

Sincerely,

Philip G. Schrag
Professor of Law

APPENDIX XV

PUBLIC COMMENTS FROM PATRICIA SMITH, STUDY GROUP MEMBER

Received by e-mail on March 15, 2001.

I submit the following comments on the draft report Alternative Market Mechanisms for the Student Loan Program by ED and GAO, released January 18, 2001.

1. The options analyzed in the report fairly reflect those discussed by the Market Mechanisms Study Group, mandated by Congress in the 1998 Amendments to the Higher Education Act.

2. The material on income-contingent repayment (ICR) in Chapter 7 and Appendix IV is very useful. It provides a clear analysis of policy and operational aspects of ICR that are not generally available except through the Code of Federal Regulations or unpublished Department of Education data. As the report notes, there is broad lack of understanding about the ICR program, which causes some unwarranted hostility in the community. This lack of information discourages the use of ICR in cases in which it would be appropriate, thereby working to the detriment of some borrowers, particularly those whose incomes are persistently low after leaving school. It also provides a good analysis of the current role of IRS in ICR, and options for income verification if ICR is to be expanded to the Federal Family Education Loan Program (FFELP). All this material should be retained in the final report.

3. I recommend clarification of one sentence on p. 93 of the draft, in the first sentence under ICR Usage in FDLP. The sentence now reads, "Although the ICR option appears to be more expensive for many borrowers over the full repayment term than, for example, the standard repayment plan, no ICR borrower 'overpays' interest (unless the plan has been established with an internal cross-subsidy)." This sentence should make clear that there is no internal cross-subsidy under current regulations.

4. The "call" option, proposed by the Department of Treasury in Appendix V, is a useful addition to the report, should be retained in the final report, and is worthy of further exploration in the future. On p. 102, it specifically addresses the following recurrent concern:

> "...unlike the current system in which special allowance payments provide a one-size-fits-all gross return, this option model would produce more efficient incentives for provision of all types of loans, without necessitating excess net returns for cheap-to-service loans."

The draft report, in describing this option, also notes on p. 101, "Under this mechanism, most aspects of the current FFELP could remain unchanged."

5. The Federal budget disadvantage of a one-size-fits-all gross return to lenders should be stated more prominently in the final report: Overview, the Chapter 1 Background, and any executive summary produced later. The Background makes only one brief statement regarding this problem on p. 19 when discussing the special allowance payment (SAP).

During Study Group discussion of options, however, it appeared to be very difficult to retain all of the following advantages of the current FFELP for students and institutions if one eliminated the current "one-size-fits-all gross return" to lenders.

> Students now have the benefit of interest rates set by Congress that are the same for all borrowers, whether high risk or low risk.
>
> Guaranteed student loan volume is driven by the demand of eligible students, not an annual decision by Congress or the Executive Branch. Eligible lenders can make guaranteed loans to all eligible students attending institutions participating in the FFELP who apply for a loan. Eligible lenders have an entitlement to the federal guarantee and special allowance payments.
>
> Lenders must compete for market share. Institutions and borrowers can choose among lenders on the basis of lenders' service without regard to any annual limit on how much each lender has the right to lend in FFELP.
>
> Under the current legislative structure, the FFELP is a mandatory program, does not require an annual appropriation of either loan capital or subsidy, and does not compete for funding with the discretionary student aid programs.

Thank you for the opportunity to comment on this report.

APPENDIX XVI

PUBLIC COMMENTS FROM TEXAS GUARANTEED STUDENT LOAN CORPORATION

Texas Guaranteed Student Loan Corporation
P.O. Box 201725 • Austin, Texas 78720-1725 • (512) 219-5700 • (800) 252-9743 • www.tgslc.org

Milton G. Wright
President and
Chief and Executive Officer

Board of Directors

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College Station

Albert H. Myres
Houston

Brent L. Thompson
Austin

Dr. Charles V. Wootan
College Station

Honorable
Carole Keeton Rylander
Texas Comptroller
Austin

March 16, 2001

Mr. Gene Kuehneman, Senior Economist
U.S. General Accounting Office
441 G Street, NW, Room 5928
Washington, DC 20202

Dear Mr. Kuehneman

Texas Guaranteed Student Loan Corporation (TG) is please to provide comments on the draft report, "Alternative Market Mechanisms for the Student Loan Program."

In general, we feel that the Department of Education (ED) and the General Accounting Office (GAO) have provided a thoughtful analysis of alternative methods of setting lender yields, as was directed by Congress. However, we also feel that the government's primary interest — to provide financing for Americans to pursue college — is at risk of being trumped by cost-cutting schemes or narrow minded parochial purposes of some that may weaken the FFELP program and compromise the overall intent of public policy. We have a few suggestions that we would ask you to consider before submitting the report to Congress.

The report outlines in a critical and balanced way the pros and cons to each of the various reforms. However, the report loses this important objectivity in the overview of the Federal Direct Student Loan Program on pages 22 – 23. Here the report contains only the "positive" side of Direct Lending without any of the GAO's own mitigating analysis of the cost-savings purported by ED ("Key Aspects of the Federal Direct Loan Program's Cost Estimates," January 2001).

The report leads the inexperienced reader to come away with the conclusion that *every* FFELP model, both current or imagined, is compromised by critical problems, but that Direct Lending offers a clear panacea. This is simply not true. The Direct Loan Program, for all its benefits to schools and students continues to lose customers while the FFELP through private lenders and guarantors is delivering over $28 billion annually and growing as schools leave the Direct Loan Program. Furthermore, there is no consensus in the government that Direct Lending saves money. We urge you to temper the claims made on pages 22 – 23, such as "FDLP has achieved billions in savings for students and taxpayers" with information from the January 2001 GAO report cited above.

One consequence mentioned in several models considered by the report is the possible elimination of small and regional lenders, because only large national lenders will have the financial leverage to take advantage of the reduced margins imagined in the various models. The reduction in the number of lenders may seem tempting as the government looks for "low cost providers" of capital, however, more could be lost than gained. The regional focus of many lenders — and guarantors — contributes to student access. For example, many local lenders and guarantors (and national lenders and guarantors functioning in local markets) tailor default prevention assistance to *individual* schools based on the cultural, financial, and demographics needs of their students. Many local lenders and guarantors return excess revenues from their FFELP business in the form of scholarships to students in the locally served markets. Again, large lenders *may* allow reduced costs, but local lenders can nearly always promise *access*, especially to segments that would be risky or unprofitable for large lenders, such as to economically disadvantaged students and the schools that serve them.

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Page two
Mr Gene Kuehneman
March 16, 2001

In some cases, the report recommends "set-asides" in auction privileges for small and local lenders. We urge caution on the use of set asides. If not properly monitored, set asides for small organizations have in other situations easily end up in the hands of large companies, as was recently seen in the wireless airwave frequency auction. The *New York Times* reported ("Wireless Giants Won F.C.C. Auction Unfairly, Critics Say," February 12, 2001) on the way large telephone companies set up temporary partnerships with small companies as a way of gaining access to their set-asides.

The prevailing assumption of the report that the large lenders envisioned in some of the proposals will always be capable of providing capital at a lower cost should be considered carefully. In a recent case involving SBA loans, a large financial institution — Heller Financial — has dropped out of the SBA program because it could not compete with small lenders. A March 12, 2001 report on *Business Week Online* states that, "...since Heller has to raise funds through money and capital markets, it was unable to compete with banks' access to low-cost deposits."

Aside from mentioning the risk to small lenders in the various models, the report does not fully explore how the various mechanisms could dramatically alter the entire student loan delivery system and the roles of the participants that currently contribute to its success. For example, under some of the auction scenarios, lenders would be coming and going from the program depending on their success with bidding. This could lead to continuity problems for students *unless* a few very large servicers and student loan trustees step in to manage the disruptions that could occur. For example, if a student has a loan made under a Master Promissory Note (MPN) with lender "A", but lender "A" fails to win origination rights in a given year, the student's MPN will not be valid for new funds under lender "B" (who did win origination rights) unless lender "A" transfers the MPN to lender "B." Aside from letting the student fend for him/herself, someone will have to manage all the various relationships between the student, the lenders, the promissory notes, and the student's account. This role would likely be provided by a few large servicers or secondary markets acting as trustees for various large lenders. Secondary markets and lender trustees will need to assume the added costs of providing this service. Guarantors could also perform this service, but as pointed out immediately below apparently the continued presence of guarantors is not envisioned in this scenario.

The guarantor role would be altered in many of the models. The report admits this (page 27) and explains that further analysis will be required in order to specify how the guarantor role could change. The question the Congress should ask itself: Is the disruption to schools and students that would inevitably results from changing the entire delivery system worth the potential cost-savings to the government? Or, will new costs simply be shifted to schools who will have to manage the transition in the delivery of loan funds (which currently occur at a very lost cost to schools)?

In general, we feel that the risks to changing the current FFELP are not overcome by any clear benefits in any of the proposed models, nor by Direct Lending. The "Adjustments to the Current FFELP System" presents a scenario with the lowest threshold of change, but it too has problems. The proposed "Blue Ribbon Commission" as a method of setting lender yield may prove to be just as politically problematic as is Congress today and may not allow lender yields to be set over and above political fiat. The Blue Ribbon Commission would have to work behind closed doors like the Board of Governors of the Federal Reserve, or else it will only be a proxy for the same problems that lawmakers are trying to avoid by proposing that the lender add-on be set in the market instead of in the halls of the legislature.

To the credit of the ED and GAO authors of the report, most of the models for reform point out the potentially negative consequences of each model. But since the foremost goal of Congress is to provide access to higher education, and since that goal is currently being served through the FFELP and other Title IV programs, it makes little sense to substitute the more important access goal with a subordinate goal of "possible" cost savings — especially if cost-savings is not "conclusive" as the analysis admits for every model.

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Page three
Mr. Gene Kuehneman
March 16, 2001

In some scenarios in the report, costs to the federal government could even go up. It would be a tragedy indeed to increase the cost to the taxpayers while limiting access to students. It is not a risk worth taking.

The study presents some interesting scenarios for reform and there is no doubt that the conversation started by this report will continue. However, in the larger interest of preserving the good work that has already been accomplished for students, Congress should continue to work with the student loan community to come up with additional visionary approaches.

Sincerely yours,

Milton O. Wright
President and CEO

Cc: Secretary Roderick Paige
Deputy Secretary Bill Hansen

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GLOSSARY

Basis Risk
A lender's risk that the basis of the interest rate at which he or she borrows to finance a loan and the basis of the interest rate that he or she receives from the loan will not move in tandem.

Borrower
The person responsible for repaying a loan who has signed and agreed to the terms in the promissory note.

Budget Scoring
The process of estimating the budgetary effects of pending and enacted legislation and comparing them to limits set in the budget resolution or legislation. Scorekeeping tracks data such as budget authority, receipts, outlays, the surplus or deficit, and the public debt limit. For purposes of the congressional budget process, the budget committees and CBO are responsible for scoring legislation in relation to the levels set by the Congress in budget resolutions and the Budget Enforcement Act.

Capitalization
The addition of unpaid interest to the principal of a loan. Capitalizing interest increases the principal amount of the loan and the borrower's total cost of the loan.

Collection Cost
The cost the government incurs and charges to the borrower when collecting a delinquent or defaulted loan.

Commercial Paper
Short-term, unsecured promissory notes, issued primarily by corporations, with maturities up to 270 days. Many companies use commercial paper to raise cash for current transactions, and many find it to be a lower-cost alternative to bank loans.

Consolidation
The combination of multiple loans into a single new loan to simplify loan repayment. Also known as refinancing.

Debt Burden
The ratio of a borrower's loan payments to the borrower's income.

Default
Defined in FFELP as the borrower's continuous delinquency or failure to make a payment for 270 days in the case of a loan repayable in monthly installments or 330 days in the case of a loan repayable in less frequent installments. If the delinquency persists for 270 days, the holder will file a default claim with the guarantor. The guarantor will review the claim to ensure that the account has been serviced (that minimal due diligence has been followed) according to regulatory requirements. If the holder is able to prove that the account has been serviced

properly, the guarantor will purchase the loan from its holder. The guarantor, in turn, will request reimbursement through its reinsurance agreement with the Secretary of Education.

Deferment
A period during which borrowers do not need to pay a loan's principal and, for subsidized Stafford loans, the federal government pays interest. Borrowers are eligible for a deferment during unemployment, while going on to further postsecondary education, and under certain other conditions.

Dependent Student
A student who does not meet the criteria for being classified as independent. See Independent Student.

Due Diligence
Compliance standards prescribed by federal regulations that govern loan making, disbursement, and servicing in the FFEL program. For example, due diligence in loan collection servicing requires that in the event of a delinquent loan, a lender shall engage in at least the collection efforts described in federal regulations.

Event Risk
The risk that market conditions will change during an auction.

Forbearance
Permitting the temporary cessation of payments, allowing an extension of time for making payments, or temporarily accepting smaller payments than were previously scheduled. A lender may grant forbearance of payments of principal and interest, according to conditions specified by federal regulations, for up to a year at a time if both the borrower or endorser and an authorized official of the lender agree to the forbearance in writing.

Government-Sponsored Enterprise
A financial institution, established by federal law but privately owned and directed, that operates in the private sector capital market.

Income Percentage Factor
A factor that corresponds to a borrower's adjusted gross income as shown in the income percentage factor table in a notice published annually by the Secretary of Education in the *Federal Register*.

Income Threshold
An income level below which loan borrowers are not required to make repayment.

Independent Student
Student who, by meeting certain regulatory criteria, is presumed to receive no financial support from parents. A student is considered independent if he or she is: at least 24 years old, a graduate or professional student, a veteran of the U.S. armed forces, married, or has dependents

other than a spouse. A financial aid administrator may also classify a student as independent under special circumstance, even if none of these criteria are met.

Interest
An expense of borrowing money that is calculated as a percentage of the amount borrowed.

Interest Spread
The difference between a lender's yield and its funding costs (costs related to capital acquisition and interest expenses).

Lender of Last Resort
A lender who lends to borrowers who are unable to obtain loans from other lenders.

Lender Yield
The face value of the lender's interest rate on an FFELP loan, set in legislation as the CP rate plus 1.74 percentage points when the student is in school or during other nonrepayment periods and 2.34 percentage points when the student is in repayment.

Loan Volume
The dollar amount or number of loans committed. It may be reported in thousands or millions of dollars.

Margin
A market-based add-on to a market rate. A margin can be negative, and it changes on the basis of market conditions and the creditworthiness of the borrower.

Market Mechanism
An interaction of buyers and sellers, in which prices or interest rates are established on the basis of the amounts of money buyers are willing to pay or sellers are willing to accept.

Markup
An amount to be added to a reference rate to determine the new derived rate.

Match Funding
Lenders matching the basis of the interest rate at which they borrow to finance a loan with the basis of the interest rate that they receive from the loan. If they are able to do so, then changes in the interest rate affect their costs and revenues identically and do not affect their net profits. If their funding costs and their revenues are based on different interest rates and those rates do not move in tandem, then their net profits could fluctuate. Hedging reduces or eliminates these fluctuations.

Multiple-Price Auction
An auction in which all accepted bids are filled at the price that each bidder bid.

Multiple-Round Auction
An auction in which a set of related items is auctioned simultaneously, with the auctioning continuing for multiple rounds until the best possible price is obtained for all items.

Negative Amortization
A gradual increase in loan debt that occurs when the monthly payment is insufficient to cover the interest due, and the balance owed continues to increase because unpaid interest is capitalized.

Open-Outcry Auction
An auction in which bidders submit bids publicly and then have the opportunity to revise their bids in light of other bids.

Operating Expense
An expense incurred by a guaranty agency, such as salary and costs for travel, computer hardware and software, equipment, rent, and supplies and contractor costs.

Origination Fee
A fee charged and deducted from the proceeds of an FFEL program loan before the loan is disbursed. It offsets some of the administrative costs of loan processing. It must not exceed the maximum rate established by law. This fee is deducted from the interest and special allowance the federal government pays the lender. Generally, lending institutions pass this fee on to borrowers when loans are made.

Present Value
The value today of a stream of payments in the future, discounted at the prevailing interest rate. According to the regulations of the Federal Credit Reform Act of 1990, the cost of a direct loan to the government is the net present value (when the direct loan is disbursed from the financing amount) of estimated cash flows—that is, loan disbursements, repayment of principle, interest repayment. For loans made, guaranteed, or modified in fiscal year 2001 and thereafter, the cash flow estimated for each year (or other time period) is discounted by using the interest rate on a marketable zero-coupon Treasury security with the same maturity from the date of disbursement as that cash flow.

Principal Balance
The amount owed on a loan or loans at any given time. It may include capitalized interest.

Promissory Note
A legally binding contract between a lender and a borrower that contains the terms and conditions of the loan, including how and when it must be repaid.

Proprietary School
A postsecondary institution that is operated for profit.

Reference Rate
An interest rate on a cash market instrument used, or referred to, in a formula for calculating another rate.

Repayment Period
The period during which a borrower is responsible for repaying his or her loan. For Stafford loans, this period begins on the day after the last day of the grace period. For PLUS and SLS loans, this period begins on the day the loan is fully disbursed. The maximum standard repayment period is 10 years, not including any authorized deferment or forbearance periods.

Risk
Lenders' risks in FFELP include

Interest rate risk or basis risk. The risk that changes in interest rate levels and the spreads among different interest rates increase the volatility of returns, reduce returns, or create losses.

Political or regulatory risk. The risk that a program might be affected by unexpected legislative or regulatory changes.

Credit risk. The risk of loss from borrower delinquencies or defaults, which is almost but not completely ameliorated by guaranty agencies and the federal reinsurance guarantee.

Servicing risk. The risk of mistakes and errors that may occur when servicing a loan can create credit risk for the lender because improper servicing can void the federal guarantee on student loans.

Sealed-Bid Auction
An auction in which each bidder submits a single bid and then all bids are opened at once.

Secondary Market
Financial institutions that purchase student loans from lenders and provide liquidity to the student loan market.

Securitization
Selling debt securities to investors with groups of loans serving as collateral for the debt.

Single-Price Auction
See Uniform-Price Auction.

Single-Round Auction
An auction in which an item or a set of items is auctioned off with one single-round of bidding.

Special Allowance Payment
A quarterly payment the government makes to FFELP lenders when lender yield exceeds the maximum borrower rate.

Uniform-Price Auction
An auction in which all successful bidders pay the same price, even if they submitted bids at different prices.

U.S. Treasury Bill
A negotiable debt obligation issued by the U.S. government and backed by its full faith and credit. The shortest term, regularly offered Treasury debt securities are 91-day T-bills.